

The Tax Aspects of Acquiring a Business

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Second Edition

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Abstract

Tax considerations are seldom the determining factor in deciding whether to purchase a business. However, taxes often affect the price and form (e.g., purchase of stock or purchase of assets) the acquisition takes. This is true because the form of the transaction affects the buyer's present value of after-tax future cash flows and therefore the price the seller will receive.

The tax implications of the purchase and sale of a business largely depend upon who the buyer and seller are and what is being bought and sold. The business being purchased may be an unincorporated proprietorship, a single owner limited liability company (LLC), a partnership (or an LLC with more than one member), a C corporation, or an S corporation. The form of the sale (asset or stock) affects the character of the seller's gain (ordinary or capital) and the buyer's basis of the assets. The buyer's basis will eventually become tax deductions.

Just as the price the buyer is willing to pay is based on the projected present value of the after-tax proceeds, the price that is acceptable to the seller will depend upon his or her expected after-tax proceeds. Each party must be aware of the other party's tax consequences to achieve a rational agreement.

Keywords

applicable federal rate (AFR), contingent liabilities, contract price, cost recovery period, covenant to not compute, depreciation

recapture, goodwill, gross profit ratio, installment sale, limited liability company (LLC), qualified indebtedness, section 197 intangible assets, tax basis, tax lives

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CHAPTER 1

The Purchase and Sale of an Unincorporated Business

The value of a business is the present value of the future net-of-taxes cash flows the business will produce. A tax adviser has little influence over the pattern of future revenues a corporation may earn, but the tax adviser may have some influence over the deductions allowed in calculating the taxable income. An important determinant of future tax deductions is how the purchase price is allocated among the assets.

Assets Valuations

The basic assets of an unincorporated business can be viewed as future tax deductions that will yield cash flow equal to the owner's marginal tax rate in the year of the deduction multiplied by the amount of the deduction. The *tax lives* that are used to allocate the assets' costs over their lives are established by the Internal Revenue Code and Regulations. Therefore, once the costs of the various assets, their tax lives, the tax owner's expected tax rate, and discount rate are determined, the present value of future tax benefits can easily be determined. Assuming the tax rate does not change, the shorter the cost recovery period, the greater the present value of the cash flow from the asset.

The purchase of an existing business is the acquisition of more than identifiable tangible assets. Tangible assets generally can be purchased in an open market for a price that is based on the expected present value of the asset's future after-tax cash flow. The unique value of a particular business lies in its intangible assets. The intangible assets can create a return above and beyond what can be derived solely from the replaceable tangible assets. The business may have a variety of intangible assets (e.g., a workforce in place, technical know-how, satisfied clientele, books and records, going concern value), some of which may be difficult to isolate. Often, the intangibles are lumped together into something called *goodwill*. It is generally not necessary for tax purposes to identify specific intangible assets, because the intangibles acquired with a business are all treated the same, with a few exceptions.¹

A commonly used method of valuing the business as a whole is the capitalization of expected future cash flows. That is, the business is worth a multiple of its expected annual cash flow. For example, a business may be valued at 10 times its expected annual cash flows. Once total price of the unincorporated business is determined, for tax purposes, the price must be allocated among the assets that constitute the business. The Tax Code and regulations (Reg. §§1.1060 and 1.338-6, and 7) provide a specific order for allocating the total purchase price to specific assets on the basis of their fair market values.² The intangibles are usually the most difficult to value because each intangible is unique. Internal Revenue Service (IRS) is aware of the valuation problems, and therefore, the regulations require that the purchase price of the business must first be allocated to assets such as marketable securities whose value is easily determined.³ Next, the remaining purchase price must be allocated to tangible assets,

such as plant and equipment, to the extent of their market values. Generally, the remaining purchase price is allocated to the business intangibles. More specifically, the regulations place each assets into one of the following seven classes of assets:

Class I: cash and cash equivalents;

Class II: actively traded personal property as defined in section 1092(d), certificates of deposit, and foreign currency;

Class III: accounts receivable, mortgages, and credit card receivables which arise in the ordinary course of business;

Class IV: stock in trade of the taxpayer or other property of a kind, which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers during the ordinary course of his trade or business;

Class V: all assets not in Class I, II, III, VI, or VII;

Class VI: all Section 197 intangibles except goodwill or going concern value; and

Class VII: goodwill and going concern value.

Goodwill and going concern value is the residual after the price has been allocated to the other classes.

Generally, classes VI and VII are the section 197 intangible assets

acquired as a part of existing business purchased by the taxpayer. With a few exceptions, their cost can be amortized over 15 years. This is generally true regardless of the legal or economic life of the particular asset.⁴ Thus, if the buyer of an extended care center paid a premium for the fact that the facility was operating at a certain capacity, the premium paid must be amortized over 15 years, although the patients might not be expected to remain in the facility for another 15 years.

Some of the exceptions to the 15-year amortization of intangibles are leaseholds and mortgaging service contracts.⁵ These assets can be amortized over their legal lives. Also, *off-the-shelf* computer software can be amortized over 5 years,⁶ but the seller's custom-made software is a section 197 intangible that is subject to 15-year amortization.

As previously discussed, the present value of the future deductions for the cost of assets depends upon the cost recovery period for tax purposes as well as the owner's marginal tax rate and discount rate. The following are some asset classes, their cost recovery periods, cost recovery methods, and the present value of the cost recovery deductions, assuming a 37 percent marginal tax rate for an individual, or a 21 percent marginal tax rate for a corporation and a 10 percent discount rate. Thus, an individual's tax benefits are 29 percent of the cost of a tractor, whose cost recovery period is 3 years, and 11 percent of the cost of a commercial building. For intangible assets, the tax benefits are almost 11 percent (0.107) of the cost of the asset.

Under the modified asset cost recovery system (MACRS), all depreciable assets are *assigned to a class*. Typical assets with their class lives and depreciation methods, along with expected tax

benefits, are available for bargaining with the buyer as shown in Table 1.1.

As discussed earlier, the purchase price of the business must be allocated among the assets acquired and the final allocations can affect the present value of the tax benefits of the depreciation and amortization. Obviously, there can be differences of opinions among *experts* about the value of an asset. In the following example involving a corporation with a 21 percent tax rate, Appraisal 2 allocates more value to the land and building than Appraisal 1. Because the land will produce no tax benefits until it is sold, and the cost recovery period for the building is 31.5 years, the present value of the tax benefits of Appraisal 2 is 20 percent less than the Appraisal 1 tax benefits.

Under the 2017 Tax Act, all of the cost of tangible personal property with a depreciable life of less than 20 years can be expensed in the year of purchase. (The immediate write-off is referred to as *bonus depreciation*.) Therefore, the cost of equipment in Table 1.2 can be deducted in the year of purchase, and the present value of the tax benefit for the Appraisal 1 is $.21 \times \$450,000 = \$94,500$, and the value of the tax benefits for Appraisal 2 is $.21 \times \$300,000 = \$63,000$.

Table 1.1 Tax benefits as a proportion of cost

Class	Typical assets	Depreciation method	Present value of depreciation @ 0.10 discount rate	Tax benefits as a proportion of asset's cost (0.37 tax rate)	Tax benefits as a proportion of asset's cost (0.21 tax rate)
1year	Supplies	Expense	1.0	0.37	0.21
3year	Small tools, tractors, horses, specialized manufacturing devices	200% decl. bal.	0.83	0.307	0.175
5year	Computers, autos, light trucks, small aircraft, construction equipment	200% decl. bal.	0.773	0.286	0.162
7year	Office furniture, fixtures and equipment, commercial aircraft, and most machinery	200% decl. bal.	0.722	0.267	0.152
10year	Specialized heavy manufacturing machinery, mobile homes	200% decl. bal.	0.654	0.242	0.137
15year	Intangibles	Straight line	0.508	0.188	0.107
27.5year	Residential real estate property	Straight line	0.337	0.125	0.071
31.5year	Office and other non-residential real estate	Straight line	0.30	0.112	0.063

Table 1.2 Tax benefits under different appraisals

	Appraised value of assets 1	Present value of tax benefits	Appraised value of assets 2	Present value of tax benefits
Accounts receivable	\$70,000	\$14,700	\$50,000	\$10,500
Equipment	\$450,000	\$94,500	\$300,000	\$63,000
Building	\$600,000	\$37,870	\$720,000	\$45,444
Land	\$250,000	\$0	\$400,000	\$0
Secret formulas	\$130,000	\$13,843	\$50,000	\$5,324
Goodwill and going concern value	\$300,000	\$31,946	\$280,000	\$29,816
Total	\$1,800,000	\$192,409	\$1,800,000	\$158,084

As a practical matter, the buyer and seller must agree on the allocation of the purchase price. This is true because tax forms must be filed by the buyer and the seller disclosing the allocations.⁷ Differences between the buyer's and the seller's allocations will likely trigger an IRS examination. In the previous example, the buyer would prefer the allocations in Appraisal 1 because of the greater present value of the tax benefits. But the seller would benefit from Appraisal 2 because it yields a greater gain from the land and building, which are eligible for capital gain treatment, and less ordinary income (\$20,000) from the accounts receivable and equipment (\$150,000 as recapture of depreciation). Appraisal 2 yields \$170,000 more capital gain and \$170,000 less ordinary income for the seller. For the seller, the capital gain and ordinary income difference could be the difference between the ordinary and capital gains rates multiplied by \$170,000. Typically, this would be $(0.21 - 0.15) \$170,000 = \$10,200$. Because of these differences, and the need for consistency between the buyer and seller, it becomes necessary for the buyer and seller to renegotiate the allocation of the purchase price. Thus, for example, the seller may agree to the first allocation only if the price is increased to \$1,820,000. The increase in price would be allocated to the goodwill, since goodwill is the residual. As such, the buyer will

recover (in present values) $\$20,000 \times 0.107$ (see Table 1.1) = \$2,140 in tax benefits, for an after-tax increase in cost of $\$20,000 - \$2,140 = \$17,860$.

The bonus depreciation rules will be phased out between 2023 and 2027. Section 179, which is not to be phased, allows expensing up to \$1,000,000 per year the cost of tangible personal property and certain building improvements.

Class IIIA

As a result of the 2013 tangible personal property regulations, a new class of property may have been created. That is, under the tangible personal property regulations, taxpayers can elect to expense *de minimis* amounts paid for the property. Small supplies costing \$200 or less per item can be expensed. Moreover, other tangible property such as equipment can be expensed in the year of purchase, provided the taxpayer has adopted a policy of expensing those items for financial accounting purposes. The per item maximum deduction is \$5,000.⁸ The election cannot be made for inventory or real estate. Under the financial conformity requirements, the taxpayer, generally, must issue certified financial statements. However, taxpayers who do not issue certified financial statements can expense as much as \$500 per item. For example, if the business being purchased included 10 laptop computers with a value of \$400 each, the cost of those computers could be expensed in the year the business was purchased. Likewise, small tools and office supplies purchased could also be expensed.

Recap

In short, the allocation of the purchase price affects the future tax

benefits to the buyer and the present tax cost to the seller. Moreover, as a practical matter, the buyer and seller must agree to the allocations as well as the total price. It follows that the allocations will often affect the price.

Contingent Amounts

The contract for the purchase of the business may contain contingent amounts. For example, the seller may receive 10 percent of earnings for a period of years. Generally, the contingent amounts paid will be added to the cost of the intangible asset, assuming the noncontingent amount is equal to or greater than the fair market value of the assets in Classes I through IV. The amortization period is the remaining number of years from the original purchase. Thus, a contingent payment in the 3rd year after the original transactions will be amortized over 12 years.

Effects of Cost Classifications

Table 1.3 illustrates the benefits to the buyer and detriment to the seller of reclassifying \$1 of cost from one of the other asset classes to intangibles. Generally, the buyer will benefit if the cost of the intangible is allocated to tangible personal property whose depreciable lives are less than 15 years. On the other hand, this same reclassification is a detriment to the buyer of an almost equal amount, because the gain is reclassified as ordinary, rather than capital gain. However, both the buyer and the seller benefit from reclassifying the price from real estate to intangibles. This is not to suggest that the buyer and seller are free to allocate the price in any manner they can agree to. However, the real estate and intangible assets are frequently the most difficult to value, and thus, the buyer and seller have some ability to allocate in a tax efficient manner.

Table 1.3 Present value of tax benefits of the cost of tangible versus intangible assets

Class	Typical assets	Tax benefits as a proportion of asset's cost (0.21 tax rate)	From intangible—buyer benefit (detrimment)	From intangibles—seller's benefit (detrimment)
1 year	Supplies, and tangible property eligible for bonus depreciation	0.21	$0.21 - 0.107 = 0.103$	$0.15 - 0.21 = (0.06)$
3year	Small tools, tractors, horses, specialized manufacturing devices	0.175	$0.175 - 0.107 = 0.068$	$0.15 - 0.21 = (0.06)$
5year	Computers, autos, light trucks, small aircraft, construction equipment	0.162	$0.162 - 0.107 = 0.055$	$0.15 - 0.21 = (0.06)$
7year	Office furniture, fixtures and equipment, commercial aircraft, and most machinery	0.152	$0.152 - 0.107 = 0.045$	$0.15 - 0.21 = (0.06)$
10year	Specialized heavy manufacturing machinery, mobile homes	0.137	$0.137 - 0.107 = 0.02$	$0.15 - 0.21 = (0.06)$
15year	Intangibles	0.107	0	0
27.5year	Residential real estate property	0.071	$0.071 - 0.107 = (0.036)$	0
31.5 year	Office and other nonresidential real estate	0.063	$0.063 - 0.107 = (0.044)$	0
N/A	Land	0	$0.0 - 0.107 = -0.107$	0

The Use of Debt

The price paid for the business, regardless of how the purchase is financed, becomes the purchaser's total basis in the assets, and therefore, future deductions. However, the actual cash required of the buyer at the time of the purchase is reduced by any of the seller's liabilities the buyer assumes, any amounts the buyer borrows from third parties, and the amount of seller financing. That is, the cost of the assets includes the buyer's equity and debt undertaken for the purchase, and not merely the purchaser's equity in the property.⁹ The buyer can increase the present value of the tax benefits of depreciation and amortization through the use of debt. The buyer may be able to borrow from the seller, or third parties, which might include the seller's creditors, with the buyer anticipating paying the liability out of the cash flow from earnings. Thus, the buyer can enjoy the tax benefits of amortization or depreciation before he or she actually pays the purchase money. For example, assume that the buyer in the previous example used \$1,200,000 of his or her money and borrowed \$600,000 to acquire the business. The cost of the assets is \$1,800,000, and the buyer enjoys the same depreciation and amortization whether the asset is purchased from the buyer's capital or from borrowed funds.

Often the use of debt may not be out of necessity but rather out of a desire to leverage the owner's equity. On the other hand, the buyer's own cash may be inadequate to complete the acquisition, but the seller is willing to be a creditor.

Installment Sales

Borrowing from the seller can be in the form of an installment sale of the assets. In an installment sale, the seller can defer the taxable gain, spread it over the years the payments are received, and thereby, increase the present value of the after-tax proceeds. With an installment sale, each dollar the seller receives will include a portion of his or her basis in the assets, interest income, and taxable gain. The buyer's cost of an asset—and therefore the buyer's cost recovery deductions—is based on the total purchase price, regardless of whether the total price has been paid in cash and regardless of whether the seller has recognized his or her gain.

The installment method may be attractive to the seller because he or she can earn a return on the installment gain (included in the interest bearing installment note) before the tax on the gain is due.

For example, assume that seller had no basis in the assets and can sell the asset for \$1,000,000 cash on the date of the sale, or for \$1,000,000 to be paid in 1 year plus interest at 8 percent in 1 year. The interest rate on the note is the same as the seller's return on alternative investments, and the seller's tax rate is 20 percent in all years. With an all cash sale, the seller would receive in the year of sale after tax $(1 - 0.20) \times \$1,000,000 = \$800,000$, which he would invest for 1 year at 8 percent before tax. In 1 year, the seller would have $\$800,000 \cdot (1 - 0.20)(0.08)(\$800,000) = \$851,200$. With an installment sale, the seller will collect in 1 year $(1.08)(\$1,000,000) = \$1,080,000$ and pay tax of $(0.20)(\$1,080,000) = \$216,000$,

leaving an after-tax amount of \$864,000. Mathematically, deferring the installment sales gain is equivalent to taxing the gain in the year of the sale and exempting the return on the investment of the assets.

After-tax proceeds in year of sale $(1 - .20)(\$1,000,000) =$	\$800,000
Return @ 8 percent on the after-tax proceeds	<u>\$64,000</u>
	\$864,000

The seller does incur the risk that the installment obligation will not be paid, but that risk would also be incurred on alternative investments made from the proceeds of a cash sale.

The gains on some assets cannot be reported by the installment method, and losses cannot be reported by the installment method. Gains on depreciable equipment used in the business (i.e., depreciation recapture on tangible personal property) and gains from the sale of inventory, which are taxable in the year of the sale, are not eligible for the installment method¹⁰; however, generally, these assets do not sell for a great deal more than their book value. The gains from the sale of capital assets, including intangible assets (e.g., goodwill), and land and buildings used in the business are eligible for installment sale treatment. As discussed earlier, the real value of a business will lie in the intangible assets, which are eligible for installment reporting.

It may be feasible to separate the assets sold for cash and those sold for installment notes. The property that is not eligible for installment sale treatment can be specified in the contract as sold for cash, and the eligible property deemed sold for cash and installment notes. For example, assume the seller in the previous example will pay \$1,200,000 at closing and a 5-year 6 percent installment note for \$600,000. The valuations and bases are

presented in Table 1.4:

Table 1.4 Assets eligible for installment sale

	Appraised value of assets	Seller's basis	Seller's gain (loss)	IS = Eligible for installment sale
Accounts receivable	\$70,000	\$80,000	(\$10,000)	
Equipment	\$450,000	\$300,000	\$150,000	
Building	\$600,000	\$300,000	\$300,000	IS
Land	\$250,000	\$100,000	\$150,000	IS
Secret formulas	\$130,000	\$0	\$130,000	IS
Goodwill and going concern value	\$300,000	\$0	\$300,000	IS
Total	\$1,800,000	\$780,000	\$1,020,000	

Rather than a cash sale with the seller recognizing \$1,020,000 income in the year of the sale, the parties could structure the transaction as a cash sale of the accounts receivable and equipment for \$520,000 yielding \$140,000 ordinary income (\$520,000 – \$80,000 – \$300,000). The other assets, all eligible for capital gains, are sold for \$680,000 cash at closing and an installment note for \$600,000. The installment sale gain from the capital assets will be reported as payments are received according to the following formula¹¹:

(Installment Sale Gain/Contract Price) × Collection	
Installment Sale Contract Price = (\$1,800,000 – \$520,000	
ordinary income assets) = \$1,280,000	
Installment Sale Gain = (\$1,280,000 – \$300,000 –	
\$100,000) = \$880,000	
Gross Profit Ratio = \$880,000/\$1,280,000 = 0.6375	
Gain recognized at closing, ordinary income from	
receivables and equipment =	\$140,000
Installment sale gain from collections in year of	
sale = (0.6375) × \$680,000 =	\$467,500
Deferred installment sale gain (0.6375) × \$600,000 =	<u>\$412,500</u>
Total gain =	\$1,020,000

Generally, liabilities of the seller assumed by the buyer are treated

as a reduction in the contract price. In the previous example, assume the seller had a \$300,000 mortgage on the land and building, which was assumed by the buyer. After the cash sale of assets that are ineligible for installment sale, and the debt assumed by the buyer, the seller will only directly receive as installment sales proceeds $\$1,800,000 - \$520,000 - \$300,000 = \$980,000$. The assumption of the liability would not be treated as an amount received by the seller; rather the numerator of the installment sales formula, the contract price, would be reduced by \$300,000, and the installment sale gain (\$880,000) would be spread over the installment sales payments that the seller directly receives from the buyer ($\$1,800,000 - \$520,000 - \$300,000 = \$980,000$). An obvious ploy would be for the seller to borrow on the property shortly before the installment sale, receive the cash from the creditor, and defer the gain. Therefore, the regulations limit the deferral treatment for the liabilities assumed to “qualified indebtedness,”¹² which generally means the debt must have been used to finance the property or the business.

Explicit and Imputed Interest

The previous discussion was based on the assumption that the buyer’s installment note bears interest at least equal to the applicable federal interest rate (AFR). If the debt instrument does not bear interest at the federal rate or greater, the installment obligation will be revalued (downward), by imputing interest. The purpose of the imputed interest rules is to prevent the seller from converting ordinary interest income into capital gain from the sale of the assets. To avoid these complications, the notes should bear interest at the federal rate or greater. AFRs are published monthly by the IRS.¹³

- Current *Short-Term AFRs* for instruments having a term of 3 years or less
- Current *Mid-Term AFRs* for instruments having a term in excess of 3 years but no greater than 9 years
- Current *Long-Term AFRs* for instruments having a term in excess of 9 years

The required rates are those for the month the purchase and sale occur. Thus, if the installment note is to be paid over 10 years, the note should bear interest throughout its term at the federal long-term rate published for the month of the sale.

When the Buyer Assumes the Seller's Accrued Expenses

The seller may owe money for services that have been performed, but have not been taken into account as an expense in calculating the seller's taxable income. If the purchaser assumes these obligations, the amount owed becomes a part of the total cost of the assets acquired. Therefore, the purchaser is not permitted a deduction when the liability is actually paid. However, the regulations allow the seller to deduct the accrued expense at the time the buyer assumes the liability. For example, assume the value of the assets is \$1,000,000 and the buyer's basis in those assets is \$600,000. The seller's only liability is \$10,000 accrued property taxes. The obligation is generally not recognized until it is paid. The buyer agrees to pay the seller \$990,000 cash and assume the seller's property tax liability for \$10,000. Under the regulations, the seller is permitted to accrue the property tax expense when the buyer assumes the obligation, and the seller is permitted a \$10,000 deduction in the year of sale. The seller also includes the liability assumed by the buyer as the amount realized.

Thus, the correct result is achieved—the seller has $(\$990,000 + \$10,000 - \$600,000) = \$400,000$ gain and \$10,000 expense. This was made possible by the regulations, which bend the tax accounting rules. The buyer will not be permitted a deduction when the buyer pays the seller's accrued expenses. Instead, the buyer will add the amount paid for the seller's expense to the cost of the assets acquired, for a total cost of $\$990,000 + \$10,000 = \$1,000,000$.

The previous rules do not apply to contingent liabilities and other liabilities for which the necessary conditions for accrual have not occurred at the time of the sale. For example, assume the seller has sold goods subject to a warranty. Further, assume that based on past experience, service under the warranty will cost 3 percent of sales, and as of the date of the sale, the estimated future claims totaled \$10,000. These claims cannot be taken into account at the time of the sale as a liability or an expense of the seller. If the buyer assumes the liability for future service, the cash paid for the business will be reduced by \$10,000, and thus, reduce the seller's gain from sale of the assets. This may mean that what should be an ordinary deduction for service under warranties becomes a reduction in capital gain from the sale of goodwill or other intangibles. On the other hand, the buyer should reduce by \$10,000 the cash he or she was willing to pay for the asset; however, the buyer will deduct \$10,000 warranty expense when the obligations are satisfied. In this case, \$10,000 is deductible as paid by the buyer, rather than \$10,000 added to intangibles to be amortized over 180 months.

Thus, the tax treatment of liabilities that will be paid by the buyer, although economically accrued by the seller, yield a tax benefit to the buyer. In the previous example, if the seller had retained the

liability for the warranty expense, the price of the business would have been \$1,000,000. If the buyer assumes the liability, the price would be reduced by the estimated amount that will be paid. The seller will then be permitted to deduct as an expense the actual payments for services under the warranty.

Lease Rather than Purchase

Another form of debt financing often used is leasing. The buyer can lease the seller's real estate used in the business. Leasing is especially appealing in the case of an anxious seller and a buyer who is cash strapped, or is simply interested in investing in an operating business rather than real estate. All of the seller's income from rent is ordinary, rather than section 1231 gain (potentially taxed as a capital gain), but the income is deferred until the rent is collected, and the seller retains the possibility of the benefits of appreciation in the property.

Covenant to Not Compete

Part of the purchase price usually includes an amount for the existing customer base, whether or not it is expressed in the purchase agreement. The benefits of the customer base could be stolen by the former owner starting a new business in competition with the business he or she just sold. Therefore, the buy-sell agreement will usually include a covenant to not compete, which prohibits the seller from competing with the sold business for a period of years. The seller will generally expect to be compensated for entering into this agreement. From the buyer's perspective, the payments under the covenant to not compete are a payment to preserve the customer base, which is an intangible asset. According to the regulations, "If, in connection with an

applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.”¹⁴ The tax law treats the cost of the covenant as if it were an additional cost of the goodwill; it follows that the buyer must amortize the payments for the covenant over the same 15-year period as other intangibles. From a tax point of view, the buyer is indifferent between an allocation to intangibles or to a covenant to not compete. However, for the seller, the payments received for the covenant to not compete is ordinary income rather than capital gain. Therefore, the seller would prefer more of the price allocated to the customer base or other intangible assets and less to the covenant to not compete, but the buyer is indifferent. As discussed earlier, the buyer and seller generally should be consistent in the allocation of the purchase price. This may give the buyer some bargaining power over the terms. That is, the seller may accept more in deferred payments for assets, rather than a covenant to not compete.

The payments over time for a covenant to not compete are installment sale payments for property.¹⁵ As such, the cost of the property must be discounted for the imputed interest. The imputed interest can be deducted as it accrues. Thus, if the buyer agrees to pay the seller \$100,000 at closing and \$100,000 each year for the next 4 years, and the imputed interest rate is 4 percent, the capitalized amount is \$100,000 plus the present value of an annuity of \$100,000 per year for 4 years with a 4 percent interest rate = $\$100,000 + \$362,990 = \$462,990$. In year 1, the buyer is permitted to begin amortizing the entire \$462,990 over 15 years, and deduct the imputed interest on that amount over the 5 years as the payments are made. The seller is allowed to spread the payments as ordinary income received over the 5 years.¹⁶

In the final analysis, typically a covenant to not compete should be included in the purchase agreement. The important tax issue is how much of the total amount that will be paid to the seller should be allocated to the covenant. For the seller, any amount allocated to the covenant is to the seller's disadvantage, when the alternative is to allocate that amount to the intangible assets eligible for capital gain and installment sales treatment.

The Former Owner as an Employee

As discussed earlier, there are tax consequences of allocating the costs among the different assets because of the differences in the cost recovery periods. Another possible reallocation is from property to services. The seller could become an employee of the purchaser. For example, the former owner may become an employee to smoothen the transition to new ownership. Assuming it makes good business sense for the former owner to become an employee, the employment contract will be intertwined with the asset purchase. As a matter of negotiation, this may result in a reallocation from intangibles—amortized over 15 years—to the employment contract, whose cost is deducted as the services are provided—usually in less than 3 years. Thus, the present value of the tax benefits of the employment contract deduction is much greater than the same amount allocated to the intangibles.

From the point of view of the seller, the tax benefits from the employment contract are equal to the marginal ordinary tax rate times the amount paid. On the other hand, an amount paid for the intangible asset yields tax benefits with a present value of 10.7 percent of the amount paid (see Table 1.1). For the seller, the amount received for the intangibles is taxed as capital gain, whereas the amount received as compensation for services is

taxed as ordinary income. For a taxpayer with a 37 percent marginal tax rate, the difference between the capital gains and ordinary income rates is generally 20 percent (e.g., capital gains rate of 20 percent and ordinary income rate of 37 percent). Therefore, a reallocation of \$1,000 from intangibles to compensation would save the buyer in the 37 percent marginal bracket $(0.37)(\$1,000) - 0.188 (\$1,000) = \$182$, but would cost the seller $0.20(\$1,000) = \200 . With a different set of tax rates, and assumed rates of return, the results could be different, as will be seen later in these materials. The important point is that employment contracts are another possible means for the buyer to shorten the cost recovery period for the investment, but this would come at the expense of the buyer.

Former Owner as a Consultant

The former owner may serve as a consultant as the business goes through the transitional effects of a change in ownership. The compensation is ordinary income for the seller, much the same as the amounts received under a covenant to not compete. However, for the buyer, if payments under the consulting agreement are diverted from goodwill, the buyer gains a tax benefit—the acceleration of the deductions for the cost of the business. Instead of amortizing over 15 years as intangibles, the compensation can be deducted as paid. As discussed earlier, the present value of the tax benefits of the 15-year amortization of intangibles is 10.7 percent of their cost, when the buyer's tax rate is 21 percent, but the tax benefit of currently deductible compensation is 21 percent of the amount paid.

Table 1.5 Benefit or detriment from allocations of price to covenant versus intangible assets

Intangibles	Covenant to not compete	Compensation for consulting	Benefit or detriment
100	0	0	
80	0	20	Buyer benefits $0.103 \times 20 = 2.06$
80	20		Seller's detriment $(0.15 - 0.37) \times \$20 = (\$4.40)$

Thus, unlike payments under a covenant to not compete, the buyer benefits from classifying part of the price as compensation for services of the former owner, rather than as goodwill or for a covenant to not compete. The seller is indifferent between a covenant to not compete and consulting fees, but prefers payments for intangibles. Table 1.5 illustrates the effects of a \$20 reallocation from intangibles to covenant to not compete or a consulting agreement, assuming the seller is in the 37 percent marginal ordinary income bracket and his capital gain rate is 15 percent and the buyer is in the 37 percent marginal bracket and has a 10 percent discount rate.

The different effects on the buyer and the seller could be used as follows: The buyer makes an offer for the business, and the seller rejects but offers to sell for a larger amount. The buyer responds as follows, “I accept your offer if x amount is allocated to the consulting agreement,” which is tantamount to making an offer between the buyer’s original offer and the seller’s offer.

The Limited Liability Company or Partnership as the Target

A single-member limited liability company (LLC) is a disregarded entity for tax purposes. Thus, the purchase of the LLC is a purchase of the assets of the LLC from the former single member.

Legally, the original LLC may be deemed to continue, unless it is formally dissolved. Therefore, the new owner of the business should take steps to prevent unknown liabilities from following the assets to the new owner.

Table 1.6 Purchase of a partner's interest

	Appraised value of assets	Seller's basis
Accounts receivable	\$70,000	\$80,000
Equipment	\$450,000	\$300,000
Building	\$600,000	\$300,000
Land	\$250,000	\$100,000
Secret formulas	\$130,000	\$0
Goodwill and going concern value	\$300,000	\$0
Total	\$1,800,000	\$780,000
A Capital	\$600,000	\$260,000
B Capital	\$600,000	\$260,000
C Capital	\$600,000	\$260,000
	\$1,800,000	\$780,000

The purchase of an LLC with more than member or a partnership can be structured as a purchase of the former owners' interests, or a purchase of the assets. With a purchase of the other members' interests, the entity terminates whenever there is a sale or exchange of 50 percent or more of the total interests in the LLC or partnership.¹⁷ Upon termination, the assets are deemed distributed to the members or partners who then sell the assets to the purchaser. Thus, the purchaser's basis in the assets is equal to the purchase price, the same as purchasing proprietorship assets. The seller (i.e., the former LLC member or partner) derives his or her basis in the assets sold from his or her basis in the LLC or partnership; that is, the entity is deemed liquidated upon the 50 percent or more change in ownership, without taxable gain or loss from the liquidation, and the member or partner derives his or her basis in the assets from his or her basis in the LLC or partnership.

Table 1.6 depicts a sale of an interest in an LLC. The LLC with three members with equal capital and profit and loss sharing ratios. If D purchased each of the three members' interests in the LLC, it will be treated for tax purposes as though the LLC distributed all the assets equally to A, B, and C. Neither the LLC nor the members would recognize gain or loss from the liquidating distributions; their bases in the LLC would be allocated among the assets received, and then the former LLC members would sell the assets to the new owner. The former LLC members will recognize gains and losses, a total of \$340,000 each ($\$600,000 - \$260,000 = \$340,000$); the character of the gain or loss (ordinary or capital) will generally depend upon the character of the asset to the LLC, and the new owner will get a cost basis in the assets \$1,800,000.

Purchase of a Partnership Interest

When the member's interests are bought or sold, the LLC (or partnership) continues. The exiting partner recognizes his or her share of the LLC's income up until the date of the sale, and then recognizes ordinary income and capital gain from the sale of his or her interest generally the same as if the LLC sold the assets and allocated the gains and losses to the exiting partner.¹⁸ However, under the general rules applicable to partnerships, the partnership's bases in its assets are unaffected by the new partner.¹⁹ This gives rise to a difference between the LLC's inside basis (the basis of the assets inside the LLC) and the member's outside basis (the member's basis in his or her LLC interest).

For example, if D purchased C's one-third interest in the aforementioned LLC for \$600,000, D's basis in the partnership for purposes of determining D's gain or loss on the sale of his interest would be \$600,000. However, the LLC would treat D as having a

\$260,000 basis in the assets within the LLC. D's basis in the building, for example, would be $\$300,000/3 = \$100,000$. If the LLC sold the building for \$600,000, D would be required to recognize a \$100,000 gain $[(\$600,000 - \$300,000)/3 = \$100,000]$. This is true even though D paid C the fair market value of C's interest in the building and all other assets.

Requiring D to recognize the gain on the building in the earlier example would clearly be an inequitable result. Therefore, the Code (in Section 754) permits the LLC to elect to adjust the partnership's bases in its assets with respect to the new partner to reflect the value he or she paid for the interest.²⁰ If the election were made, the LLC's basis in the building will be increased from \$300,000 to \$400,000. However, the basis in the building (and the other assets) is adjusted only with respect to D. Thus, if the building is sold for \$600,000, the gain will be \$200,000 $(\$600,000 - \$400,000)$, and that gain will be allocated entirely to A and B. The election creates the same result as if C's share of the assets was distributed to him, and he sold the assets to D, who in turn contributed the assets to the LLC. However, as mentioned earlier, D is at the mercy of the other LLC members to make the election to adjust bases with respect to him. If the election is not to be made, D should pay less for the interests than if the election is made.

The Purchasing Entity

Generally, to limit the purchaser's exposure to liability, the acquisition should be made through a separate legal entity, such as an LLC, or a corporation, rather than in the name of an individual purchaser. The use of a legal entity does not absolve the owner from all liability, but it can eliminate exposure to certain types of

claims.

The use of more than one entity can help avoid some major tax problems when the business (or parts of the business) is sold at a later date. For example, it is generally advisable to put real estate and identifiable intangible assets in entities separated from easily replaceable assets such as inventory and equipment. The real estate and intangible assets can be leased or licensed to the operating company. With two or more entities, new investors can be brought into the business, while the original owner retains the benefits of the real estate and intangibles. Also, for example, when the business is resold, the purchaser may not desire to purchase the real estate. Having the real estate in a separate entity may facilitate the sale of the business. For income tax and estate tax planning, the buyer may decide to give family members an interest in the real estate but not the operating business. This is easily accomplished with the real estate in a separate entity.

Another consideration regarding who should acquire the business is how the business investigation and start-up costs will be treated. As will be discussed in Chapter 6, if the purchaser is operating a business in the same line of business as the business purchased, the business investigation costs and start-up costs are deductible as business expansion costs, rather than capitalized and amortized over 180 months.

Other than business investigation cost and start-up cost considerations, the primary consideration in the choice of the entity to make the acquisition is whether the income from the business should be subjected to corporate tax. As discussed in Chapter 2, generally the corporate double-tax system renders the use of a C corporation at a considerable disadvantage. However,

in the case of a small business whose earnings do not reach the highest corporate rate, and whose after-tax earnings are used to retire the purchase money indebtedness, the C corporation may be the preferred entity particularly if the shareholder has a high marginal tax rate.

Example: A taxpayer invested \$150,000 and borrowed \$300,000 to purchase a business. Assume that income earned by the business operating as a C corporation will be taxed at 21 percent, the shareholder is in the 37 percent marginal tax bracket, and all of the after-tax income will be used to retire debt incurred to purchase the business. The business earns \$400,000 over a number of years. If doing business as a C corporation, the entity would pay tax of \$84,000 over that period.²¹ The \$316,000 after-tax income is used to pay down the debt incurred to purchase the business. At a 6 percent interest rate, the interest paid over 5 years would be \$56,000. The corporate deduction would save $0.21 \times \$56,000 = \$11,760$ compared with the tax benefits of an individual deduction of $0.37 \times \$56,000 = \$20,720$. The after-tax income will not be available for distribution to the owner, and therefore, will not be subject to a double-tax while the investor owns the stock. A second tax will be incurred by the owner when the stock is sold, but the present value of that tax may be very small.

Table 1.7 Corporation and proprietor compared

	Unincorporated	Incorporated
Ordinary income over 5 years	\$400,000	\$400,000
Income tax @ 0.37 and 0.21, respectively	(\$148,000)	(\$84,000)
Interest expense	(\$56,000)	(\$56,000)
Tax benefit for interest deduction @ 0.37 and 0.21, respectively	+\$20,720	+\$11,760
After-tax before capital gain on sale Capital gain on sale of incorporated entity (\$400 – \$84,000 – \$56,000 + \$11,760)		\$271,760
Individual capital gains tax @ 0.15		(\$40,764)
Present value of individual capital gains tax @ 0.10 in 5 years		(\$25,311)
Total tax	(\$127,280)	(\$96,061)

Before consideration of any tax on the sale of the business, the tax savings as a result of organizing the business as a C corporation is \$64,000 of income tax [(0.37 individual rate – 0.21 corporate rate) × \$400,000] less the \$6,400 reduction in tax benefit related to the interest deduction on the debt. Assuming the individual's capital gain rate is 15 percent, the tax upon the sale of the stock will be $0.15 \times \$271,760 = \$40,764$. However, assuming the stock will be held for 5 years, present value of the tax upon the sale of the stock will be far less than the additional tax paid on ordinary income by the unincorporated entity. To recap let's look at Table 1.7.

It should be noted that if the corporate tax rate had been higher (say 30 percent), incorporating would be more expensive in terms of total tax paid.

The new owners must also be concerned with personal liability. Therefore, the acquired business must ultimately be inside of an LLC or a corporation. The purchaser is not necessarily the entity that operates the business. For example, an individual could purchase a proprietorship and then transfer the assets to a corporation in exchange for stock. The transfer will be nontaxable provided the individual has 80 percent control over the transferee

corporation. Or, the individual could transfer the assets to an LLC. The transfer to the LLC would be a nontaxable event regardless of whether the individual controls the LLC. However, arrangements with creditors will be necessary for the new entity to assume liabilities.

¹ See IRC §197.

² Section 1060.

³ Reg. §1.1060.

⁴ Section 197(c).

⁵ Section 197(e).

⁶ Section 197(e)(3).

⁷ Form 8594, Asset Acquisition Statement Under Section 1060.

⁸ Reg. §1.263(a)-1(f).

⁹ *Beulah B. Crane v. Commissioner*, 331 U.S. 1 (1947).

¹⁰ Sections 453(b) and (i).

¹¹ Reg. §15A.453-1(b)(2).

¹² Reg. §15A-1(b)(2)(iv).

¹³ <http://apps.irs.gov/app/picklist/list/federalRates.html>

¹⁴ Reg. §1.1060-1(b)(7).

15 Reg. §1.197-2(k) Example 6.

16 Rev. Rul. 69-643.

17 Section 706.

18 Sections 731 and 751.

19 Section 743.

20 Sections 743 and 754.

21 If the business were not incorporated, the income tax would be \$148,000.

CHAPTER 2

The Purchase and Sale of an Incorporated Business

This chapter addresses the tax issues in acquiring an incorporated business operating as a C corporation that is not a subsidiary of another corporation. The special issues associated with purchasing and selling an S corporation are discussed in Chapter 3, whereas issues associated with purchasing a subsidiary from its corporate parent are discussed in Chapter 4.

The major difference between the purchase of a C corporation and the purchase of the assets of an unincorporated business is that the corporate acquisition brings with it the system of double taxation that does not apply to the unincorporated business. The ramifications of double taxation apply to the corporation's built-in gains at the time the corporation is acquired—that is the difference between the corporation's bases in each asset and the asset's fair market value—as well as to income earned after the change in ownership.

The form of the acquisition can be either (1) a purchase of the stock or (2) a purchase of the corporation's assets. The two approaches result in differences in the bases of the targeted assets. With an asset purchase, the buyer gets a fair market value basis in the assets, but with a stock purchase, the corporation's bases in its

assets do not change. The buyer's future taxable income is affected by the basis in the assets, and therefore, the form of the acquisition affects the price the buyer is willing to pay.

Purchase and Sale of Stock, in General

If an individual or a group of individuals sell the controlling interest in the C corporation, the selling shareholders generally must recognize capital gains or loss from the sale of the stock. The target corporation is generally unaffected by the change in ownership: It retains its bases in assets and other tax attributes (e.g., net operating loss [NOL] carryforward, accounting method). The purchaser's basis in the stock is what he or she paid for the stock. Therefore, as shown in Table 2.1, if the corporation's assets are appreciated, the purchasing shareholder's basis in the stock will be greater than the book value of the equity (i.e., corporation's basis in its assets reduced by the corporation's liabilities).

The price one would expect to pay for the stock in the corporation whose assets are listed earlier would be more than \$780,000 but less than \$1,800,000. This is true because the corporation's bases in its assets are future tax deductions that may be worth as much as \$0.21 (i.e., the corporation's marginal tax rate) for each dollar of basis; therefore, the price of the stock will not be based solely on the appraisal value of the assets, because the bases in assets are not adjusted to their fair market value following the change in stock ownership.

Table 2.1 Basis versus value of assets

	Corporation's basis	Appraised value of assets
Accounts receivable	\$80,000	\$70,000
Equipment	\$300,000	\$450,000
Building	\$300,000	\$600,000
Land	\$100,000	\$250,000
Secret formulas	\$0	\$130,000
Goodwill and going concern value	\$0	\$300,000
Total	\$780,000	\$1,800,000

To illustrate the significance of the differences between basis and fair market value, assume the stock was purchased for \$1,800,000 when the corporation's basis in its assets totaled \$780,000, and the corporation immediately sold its assets for \$1,800,000 when the corporate tax rate was 0.21 percent. The corporation would owe tax of $0.21 \times (\$1,800,000 - \$780,000) = \$214,200$. After the tax was paid, the corporation would have $\$1,800,000 - \$214,200 = \$1,585,800$ in cash. The stock would be worth only \$1,585,800, and thus, the owner of the stock would suffer an economic loss of \$214,200, which is the amount of the corporate tax. Under this scenario, the stock would be worth no more than \$1,585,200. From the seller's perspective, the assets are worth more than the corporation's basis, \$780,000, and therefore, the seller would expect to receive more than \$780,000. In reality, the buyer is purchasing a business and would probably not immediately sell all of the assets. Therefore, the significance of the difference between the corporation's basis in its assets and their fair market value becomes more complex, as will be seen later.

Purchasing a C Corporation

As discussed earlier, the parties could agree to (1) buy and sell the stock or (2) buy and sell the target corporation's assets. From a

buyer's business perspective, setting aside tax considerations for the moment, one reason the buyer would prefer to acquire assets is the possibility that the corporation has undiscovered liabilities. For example, the corporation's prior income and payroll tax returns may still be subject to audit and possible adjustments, which would be paid out of corporate assets. Also, product liability issues could emerge long after the change in ownership. These liabilities generally would not attach to the assets purchased but would remain with the corporation after a stock purchase. The purchaser would like to avoid such surprises, which would not occur if the assets (rather than stock) were purchased.

However, methods are available for the purchaser to avoid the unknown or contingent liabilities associated with a stock sale. The purchaser of the stock could shift the liability to the former stockholders by the seller agreeing to indemnify the corporation for later discovered liabilities, and perhaps a portion of the purchase price could be held in escrow to cover such contingencies. Moreover, the stock deal could benefit the purchaser by keeping the corporation's existing contracts. Therefore, the two forms of acquisition have their legal benefits and burdens that must be balanced. But tax considerations will also become part of the balancing act.

In the example shown in Table 2.2, the total price of an asset acquisition would equal the aggregate fair market value of the assets or \$1,800,000. However, the price of a stock acquisition should be less. This is true because the fair market value of the assets includes the present value of the tax benefit from deducting their cost (i.e., their fair market value). If the corporation's basis in its assets—the amount the corporation can deduct when assets are sold, depreciated, or amortized—is less than the fair market

value of the assets, the price of the stock will be less than the sum of what would be paid for the individual assets in a transaction in which the basis in the assets would be their fair market values. Assuming the assets will be used in the business for as long as their tax lives (i.e., the period over which their cost can be depreciated or amortized), and using the previous assumptions of a 10 percent discount rate and a 21 percent corporate tax rate, the price of the stock would be reduced by \$98,510 if the corporation's basis in the assets is not increased.¹

Table 2.2 Present value of tax benefits

	Appraised value of assets	Corporation's basis	Difference	PV \times tax rate	Effect of basis on value
Accounts receivable	\$70,000	\$80,000	(\$10,000)	0.21	(\$2,100)
Equipment ¹	\$450,000	\$300,000	\$150,000	0.21	\$31,500
Building	\$600,000	\$300,000	\$300,000	0.063	\$18,900
Land	\$250,000	\$100,000	\$150,000	0	\$0
Secret formulas	\$130,000	\$0	\$130,000	0.107	\$13,910
Goodwill and going concern value	\$300,000	\$0	\$300,000	0.107	\$32,100
Total	\$1,800,000	\$780,000	\$1,020,000		\$98,510

No adjustment was made for land because the tax benefits of basis will not be realized until the land is sold. In the example, the land is used in the business and its sale is not foreseeable. For all other assets, the cost is recoverable for tax purposes through normal operations of the business.

The purchaser would generally prefer to acquire the appreciated assets with a basis equal to their fair market value. In an asset purchase, that results in a purchase price of \$1,800,000. On the other hand, in a stock purchase in which the basis of the acquired assets remains at \$780,000, the buyer would pay no more than

$\$1,800,000 - \$98,510 = \$1,701,490$ for the stock. In essence, the buyer is saying, “I will pay the seller $\$1,701,490$ for the stock and I will pay the government $(\$1,800,000 - \$780,000) \times 0.21 = \$214,200$ in the future,” but the present value of the future tax payments is only $\$98,510$. The stock purchase without a basis adjustment is tantamount to a partially debt-financed transaction, with the government as the creditor and the interest rate set at zero.

In a stock purchase, for the corporation’s basis in its assets to increase, the purchaser must buy the assets and generally the corporation must be liquidated (an exception to the liquidation requirement will be discussed later). The corporation would sell the assets and recognize $\$1,020,000$ gain $(\$1,800,000 - \$780,000)$, pay tax on the gain, and then distribute the proceeds to its shareholders, who generally would also be required to pay tax on any gain they realize. Assuming a corporate tax rate of 21 percent, the corporate tax would be $\$214,200$ and the corporation would have only $\$1,800,000 - \$214,200$ to distribute to its shareholders. The shareholders would treat the liquidating distribution as proceeds from the sale of its stock, and thus, would recognize capital gain on the excess of the liquidation proceeds over their bases in the stock. The corporation’s built-in gain of $\$1,020,000$ would be subject to double-tax and the corporate and shareholder tax would occur almost simultaneously.

For purposes of illustration, in Table 2.3 assume the corporation has no liabilities and the selling shareholder’s basis in the stock is $\$400,000$. (The shareholder’s basis in the stock is less than the corporation’s basis in assets because the corporation has retained earnings of $\$380,000$.) Therefore, the shareholder would have a taxable gain of $\$1,800,000 - (0.21) (\$1,020,000 - \$400,000) =$

\$1,185,800 from the liquidating distribution and a capital gains tax liability of $0.15(\$1,185,800) = \$177,870$.

The corporation incurred \$214,200 tax liability when it sold its assets. As a result, the new owners received a fair market value basis in those assets. However, the value of the step-up in basis to the purchaser was only \$87,110; therefore, the sale and liquidation cost the seller \$214,200, but the benefit to the buyer was only \$98,510. The federal treasury was the beneficiary, and the seller was the victim of the transactions. As will be seen, better results can be obtained.

Table 2.3 Shareholder's after-tax proceeds from asset sale

	Corporate gain and tax	Shareholder gain and tax	After-tax proceeds
Corporate sales proceeds	\$1,800,000		
Less, basis in assets	(\$780,000)		
Corporation taxable gain	\$1,020,000		
Corporate tax @ 0.21	(\$214,200)		
Distributions to shareholder	\$1,585,800	\$1,585,800	\$1,585,800
Shareholder's basis in stock		(\$400,000)	
Shareholder's gain		\$1,185,800	
Shareholder's capital gains tax @ 0.20		(\$237,160)	(\$237,160)
After-tax proceeds to shareholder			\$1,348,640

Alternatives to Liquidation

The previous discussion assumed the corporation would be liquidated after selling its assets. This assumption is realistic because of provisions in the tax law that practically dictate liquidation following a sale of the business, unless the corporation reinvests in another operating business. If the sales proceeds are used to acquire investment assets, the company may be subject to

a personal holding company tax,² or a tax on excess accumulated earnings and profits.³ Both provisions are designed to force the corporation to distribute its earnings (as dividends) when it no longer has an operating business. If the distributions are in liquidation, the shareholders will be allowed to offset the liquidation proceeds with the shareholder's basis in the stock,⁴ while in nonliquidating distributions (i.e., distributions of investment earnings), the entire amount received by the shareholder is generally taxed as a dividend.⁵ Therefore, the sale of the assets is often followed by liquidation.

An alternative to liquidation after the assets are sold that may come to mind is to use the corporation's after-tax sales proceeds to make investments, and make an S election.⁶ The investment income could flow through from the corporation without corporate tax, and without shareholder tax on the sale proceeds. Assuming the corporation can qualify for the election, the S corporation rules impose penalty taxes on income from investment income and terminate the S elections after 3 years of excessive investment income.⁷ Again, the tax law forces liquidation.

The Seller's S Election Prior to the Asset Sale

Usually, an S election will eliminate tax at the corporate level, and the income will flow through to the shareholder, who will be required to pay the tax on the income. However, an S election made immediately before the assets were sold would not eliminate the corporate level tax. This is true because under the S corporation rules, when a former C corporation becomes an S corporation, the built-in gain for assets owned at the date of the election (i.e., \$1,020,000 in the example) is subject to the C corporation tax (at 21 percent) if the assets are sold within 10

years of the date of the election.⁸

The Stock Deal

Rather than the corporation selling its assets and liquidating, the shareholders could simply sell their stock. This would result in a capital gains tax for the shareholders in the year the stock is sold, but the corporate level tax would be deferred until the corporation sells the assets, or as the assets are depreciated (a reduction in depreciation expense is equivalent to additional taxable income), after the change in ownership. The present value of the corporate level tax would be less than the tax due upon liquidation of the corporation.

Extending the earlier example, if the price of a stock acquisition were set at \$1,650,460 (\$149,540 less than the appraisal value of the assets and the price of an asset acquisition), the selling shareholder would still have more after-tax proceeds from a stock sale as compared to an compared with an asset sale followed by liquidation. At a price of $\$1,800,000 - \$98,510 = \$1,701,490$, the shareholder's gain would be $\$1,701,490 - \$400,000 = \$1,301,490$, and the after-tax proceeds would be $\$1,701,490 - 0.20(\$1,301,490) = \$1,701,490 - \$260,298 = \$1,441,192$. As computed earlier, a sale of the assets for \$1,800,000 would yield the shareholder only \$1,348,640 after-tax. While the stock sale resulted in a \$92,552 increase in the seller's after-tax proceeds ($\$1,441,192 - \$1,348,640 = \$92,552$), the purchaser should be indifferent between a purchase of the assets for \$1,800,000 (and thus a basis in the assets of \$1,800,000) and a purchase of the stock for \$1,701,490 (and the corporation's basis at \$780,000).

The buyer and seller might agree to share the tax savings; that is,

the seller might agree to reduce the price to \$1,620,000 and accept after-tax proceeds of $\$1,620,000 - 0.15(\$1,620,000 - \$400,000) = \$1,437,000$, which is still more in after-tax proceeds from the corporation's sale of its assets and liquidation. Both the buyer and the seller could benefit from the stock sale, as compared with the asset sale.

In summary, when the corporation owns appreciated assets, the tax law favors a stock transaction rather than an asset transaction. This is true because with a sale of the corporate assets followed by a liquidation of the corporation, the after-tax proceeds to the seller will be less than the seller's after-tax proceeds from the sale of the stock. The buyer will not pay enough to compensate for the corporate level tax on the asset sale because the buyer's tax benefit from the higher basis is spread into the future—over the lives of the assets. In the example, the corporate level tax on the asset sale was \$214,200, while the present value of the buyer's tax benefits from the stepped-up basis attained in an asset purchase was only \$98,510.

The Seller's Deferred or Excluded Gain

As discussed earlier, because of the double-tax from a sale of assets, the tax law often favors a stock deal. The stock sale can be especially appealing to the seller of original issue stock, which can qualify for special treatment under IRC sections 1045 or 1202. These provisions allow an exclusion from tax the gain on the sale of qualified small business stock. Section 1045 allows the seller to exclude the gain, provided the proceeds are reinvested in another small business within 60 days of the sale. However, the seller's basis in the replacement property must be reduced by the gain, which is not recognized. Thus, section 1045 defers gain.

Section 1202 allows the seller to exclude the entire gain from taxable income for stock acquired after September 28, 2010, held for at least 5 years, and sold by December 31, 2018. Stock acquired during the interval February 18, 2009, to September 27, 2010, qualifies for a 75 percent exclusion of gain from the sale, and stock acquired before February 18, 2009, qualifies for a 50 percent exclusion of gain. Furthermore, no basis adjustment is required.

The major difference in the requirements for sections 1045 and 1202 is that the latter section requires that the taxpayer must have held the stock for at least 5 years. Either option, if available, provides an additional benefit from a stock sale, as compared to an assets sale.

Section 1202(c) defines qualified small business stock, and the definition applies to sections 1045 and 1202. In general,

- the corporation must be a C corporation (rather than an S corporation); the stock must have been originally issued (rather than purchased from another shareholder) to the taxpayer for property (rather than as compensation for services) and
- the corporation must actively conduct a trade or business (rather an investment company).⁹

The Target Has an NOL

The fact that the target corporation has an NOL carryforward can affect the price of the stock and the choice between a stock deal and an asset deal. When a corporation experiences a loss from

operations in 1 year (an NOL), the loss can be carried back to offset income in the two previous years. If the taxable income in the second preceding year is greater than the loss taken to that year, the corporation will receive a refund equal to the marginal tax on the amount of the loss.¹⁰ In the simple case of a 21 percent marginal tax rate, the refund would equal 21 percent of the loss. If the loss in the current year exceeds the income in the second preceding year, the unabsorbed loss can be carried to the immediately preceding year, and an additional refund would be received with respect to the loss applied to that year. If the loss is not fully absorbed in the two preceding years, the loss can be carried forward to the subsequent years until it is fully absorbed.

However, the loss carryforward can only reduce by 80 percent of the taxable income for the year to which the loss is applied. For example, if the loss carryforward was \$100 and the taxable income for the following year was \$40, only $.80 \times \$40 = \32 of the loss can be used in that year and $\$100 - \$32 = \$68$ will be carried forward to the next year. The 80 percent limit would be applied to the subsequent year's income until the \$100 loss is fully absorbed.

A corporation with an NOL that sells its assets and liquidates can use any unused NOL to absorb the gains from liquidation. But when ownership of the corporation's stock changes and the corporation continues (rather than being liquidated), the NOL is retained by the corporation. Because an NOL represents deductions that may be taken in subsequent years, the loss is a possible future tax benefit, and therefore, has value. However, to prevent abuse the Code limits the utilization of an NOL following a substantial change in the ownership of the stock in the corporation. Generally, if the corporation experiences a 50 percent

or greater change in stock ownership within a 3-year period, the use of the NOL is limited by a formula. Furthermore, if the corporation discontinues the business within 2 years after the change in ownership, the loss cannot be used.¹¹ Measuring the change in ownership can be complex when new shareholders buy and old shareholders sell their stocks. However, an outright purchase of control of the corporation, the situation addressed here, and the change in ownership will be sufficient to require that the loss limitation rules become operative.

Under the formula, after the change in ownership, the amount of the NOL that can be used in any 1 year is computed as follows:

$$\text{LTTER} \times \text{Value of the Corporation's Equity} = \text{annual limit on NOL applied to future years income}$$

LTTER is the average interest rate paid by tax exempt organizations for the current month and 2 months preceding the 50 percent change in ownership. These rates are published in the IRS bulletin each month.

The underlying rationale for using the LTTER is that the purchaser could have used the amount paid for the stock to purchase tax exempt securities, and thus, would have enjoyed tax exempt income. To the extent the loss is utilized, the corporation has realized tax exempt income. The value of the corporation's equity is based on the price paid for the stock, which resulted in

the change in ownership. In the simplest case of a purchase of 100 percent of the stock for \$1,000,000, when the LTTER is 4 percent, the annual limitation on the use of the NOL is \$40,000 = $0.04(\$1,000,000)$. Under the formula, the greater the NOL relative to the value of the equity, the longer the recovery period. For example, if the NOL is \$400,000 and the value of the equity is \$1,000,000 and the LTTER is 4 percent, it will take at least 10 years to exhaust the NOL.

$$\$400,000/0.04(\$1,000,000) = \$400,000/\$40,000 = 10 \text{ years.}$$

On the other hand, if the NOL is only \$200,000, in this example, the loss can be utilized in as few as 5 years.

Because the NOL is generally expected to have future tax savings, the presence of the NOL should increase the price of the stock above what the price would have been for the same corporation without an NOL. The increase in the price of the stock because of the NOL can shorten the amortization period for the NOL under the formula. In Table 2.4, the initial value of the NOL is \$42,720, assuming a 10 percent rate of return, and it will take at least 8 years (\$40,000 a year for 7 years and \$20,000 in the 8th) to fully utilize the NOL, but when the price is increased by the value of the NOL, the amortization period is reduced to 7 years. The shortened amortization period raises the value of the NOL by \$1,093 (from \$42,720 to \$43,817).

Built-in Gains

The target corporation may have built-in gains as well as an NOL. In the previous example, the corporation's basis in its assets was \$780,000 and their value was \$1,800,000. Therefore, the corporation had a net built-in gain of \$1,020,000. The Code treats a built-in gain that is realized after the change in ownership as a reduction in the NOL. Therefore, the annual limit on the use of the NOL is increased by the amount of the realized built-in gain for the year.

Built-in Losses

The target corporation may have assets whose bases exceed their fair market values. An excess of the total basis in the assets over their total fair market value is termed a net unrealized built-in loss. Referring to the earlier list of assets, their bases, and values, if the amounts in the basis and values columns were reversed (see Table 2.5), so that the total basis was \$1,800,000 and the total value was \$780,000, the corporation would have a net built-in loss of \$1,020,000. To a purchaser of the stock, with no change in the corporation's bases in assets, the value of the stock would be greater than \$780,000. This is true because the total basis in the assets is the amount of future deductions. Thus, from a tax perspective, the buyer would prefer a stock deal, with future deductions of \$1,800,000, rather than an asset deal, with future deductions of \$780,000. However, the tax law treats a net built-in loss similar to an NOL. That is, the deductions for losses that are built-in when the change in ownership occurs, but are realized after the ownership change, are subject to the same annual limitation on deductions—the LTTER \times value of the equity—as an NOL realized before the change in ownership.

Table 2.4 Calculating the present value of the tax benefits of an NOL

Value of the stock w/o NOL	NOL	Value of NOL	Value of stock and NOL	Tax-exempt rate	Tax rate	Annual limit	No. of years to utilized NOL	R of R	PV of tax benefit
\$1,000,000	\$300,000	\$0	\$1,000,000	0.04	0.21	\$40,000	7.5	0.1	\$42,720
\$1,000,000	\$300,000	\$71,501	\$1,071,501	0.04	0.21	\$42,860	7.0	0.1	\$43,817

Table 2.5 Basis exceeds value

	Appraisal value	Corporation's basis
Accounts receivable	\$80,000	\$70,000
Equipment	\$300,000	\$450,000
Building	\$300,000	\$600,000
Land	\$100,000	\$250,000
Secret formulas	\$0	\$130,000
Goodwill and going concern value	\$0	\$300,000
Total	\$780,000	\$1,800,000

Thus, if the stock in the corporation whose assets are presented earlier was purchased for \$850,000 (with a \$70,000 premium paid for the high basis in the assets), when the LTTR was 4 percent and the following year the equipment was sold for \$300,000, yielding a \$150,000 loss (\$300,000 – \$450,000), only $0.04 \times \$850,000 = \$34,000$ of the loss could be deducted in the year of the sale. The unused loss would be carried to subsequent years.

In summary, an NOL and a built-in loss are assets with value to the buyer and seller, but special rules for the amortization of the NOL limit that value in the case of a stock purchase. For the purchaser of the stock in a corporation with an NOL, the value of the NOL will be less than the NOL multiplied by the tax rate because the NOL is allocated to future tax years. As will be seen later, in an asset purchase and sale, the seller may get tax benefit from the NOL by immediately reducing gains from the sale of assets.

The NOL in a Liquidation

If the corporation's assets are purchased and the corporation is

liquidated, the NOL is applied against the corporation's gains from the liquidation, and thus, mitigates the tax consequences of the liquidation; also, the target corporation's bases in its assets are restated to equal their fair market value. The combined use of the NOL to offset gain and step-up in the target's bases in assets can eliminate the double-taxation of the corporate gain.

For example, assume the investors gave \$300,000 for the newly issued stock and the corporation spent \$300,000 on research to create a new product design. The corporation has a \$300,000 NOL and a patent that is expected to produce \$37,975 a year before tax and \$30,000 after 21 percent tax. This stream of income is expected to extend for many years. The potential buyer of the corporation's stock considers the patent as an annuity that is close to perpetuity and values the patent at \$300,000. The purchaser is willing to pay \$300,000 for the patent, but if the stock is purchased, the new owner will get the benefit of the NOL, as well as the patent. Assuming the LTTR is 0.04, \$12,000 of the loss ($0.04 \times \$300,000 = \$12,000$) can be used each year. The loss cannot be fully utilized in this example because the loss carryforward period is only for 20 years ($20 \times \$12,000 = \$240,000$). Moreover, the seller must recognize gain or loss from the sale of the stock. On the other hand, if the corporation sold its asset for \$300,000 and liquidated, the corporation would have no taxable income, as the loss carryforward would absorb the gain on the sale of the stock, and the purchaser would have a basis in an intangible asset that could be amortized over 15 years. The choice, from the buyer's perspective in terms of the form of the acquisition, is between an annuity from the use of the NOL of $\$12,000 \times 0.21$ per year for 20 years and an annuity from the amortization of the design cost of $(\$300,000/15 \text{ years} = \$20,000)$, $\$20,000 \times 0.21$ per year for 15 years. The latter alternative is

clearly preferable to the buyer, and he or she should be willing to pay a premium for the asset as compared with the price of the stock. The buyer should be neutral about the choice, assuming the corporation has no contingent liabilities, and thus, would base his or her decision solely on the amount of the premium the buyer will pay for the asset.

Resizing the Transaction

The price and the form of the transaction may be agreed upon, but the buyer may not have the funds required to pay 100 percent of the purchase price. Debt may be required to close the deal. The buyer may be able to borrow from third parties, or from the former shareholders by giving some debt for the stock; or, the corporation may purchase some of its stock—a stock redemption—in exchange for debt.

Third-Party Debt

The third-party debt may be amounts borrowed by the purchaser or by the target corporation. If the corporation borrows the funds, they will be used to redeem stock. The problem with the individual borrowing is that often the corporation's income may be the source for repaying the loan. If the corporation remains a C corporation, the stockholder must receive taxable dividends as a source for repaying the loan. Thus, the corporate level tax and the shareholder level tax occur almost simultaneously. For example, if the corporation's income is taxed at 21 percent and the shareholder tax rate on dividends paid to service the debt is 20 percent, the effective tax rate on the income is $0.21 + (1 - 0.21)(0.20) = 36.8$ percent.

When the corporation will remain a C corporation, the corporation should be the debtor, rather than the shareholder. This is true because the corporate cash flow from earnings can be used to retire the debt, without the need to pay taxable dividends so that the shareholders can repay the debt. Also, the interest will be deductible by the corporation. As the corporate debt is repaid, the book value of the corporation's equity will increase, but the shareholder's basis in the stock will be unaffected. Thus, the after-tax income used to pay the corporate debt is the shareholder's deferred income, which is deferred from tax until the corporation either distributes the assets or the shareholder sells the stock.

Example: The purchasing shareholder paid \$1,200,000 for two-thirds of the target stock, and the corporation borrows \$600,000 to redeem the stock from the other one-third shareholders. The income is taxed at the corporate level, and the debt will be repaid out of after-tax cash flow from corporate earnings. After the debt has been retired, the shareholder will have a basis in the stock of \$1,200,000 and the corporation will have a book value of \$1,800,000. Assuming the market value of the stock increases as the book value increases, the shareholder will have a \$600,000 capital gain when the stock is sold.

Borrowing from Target Shareholders

The shareholders could accept the corporation's notes payable in exchange (i.e., redemption) for their stock. Assuming the corporate obligations are not publicly traded, the shareholders can use the installment method to report their gain, thus spreading their gain over the tax years in which the receivable is collected. As discussed in Chapter 1, the shareholders are able to earn interest on the installment obligation before the gain has been

included in gross income.

The tax consequences to the C corporation borrowing from target shareholders are the same as borrowing from third parties, discussed earlier. The interest on the debt would be deductible by the corporation.

An S Election with Debt

The primary advantage of operating as an S corporation, when that option is available, is that income earned by the corporation is not taxed at the corporate level, but rather is taxable income to the shareholder in the year the income is earned. The S corporation income is added to the shareholder's basis in the stock, and distributions of the S corporation income reduce the shareholder's basis in the stock. When the after-tax corporate income is used to pay the debt incurred to purchase the stock, it generally does not matter whether the S corporation shareholder or the corporation is the debtor, except in regard to deducting the interest expense. The corporation's interest may be trade or business expense, but for the shareholder who borrows, the interest may be investment interest with the deduction limited to net investment income.

Table 2.6 S corporation versus C corporation debt financing

	S corporation	C corporation
Corporate income	\$952,381	\$952,381
Less tax @ 0.37		
S shareholder tax	\$(352,381)	
Corporate tax @ 0.21		\$(200,000)
Debt repaid with after-tax income	\$600,000	\$600,000
Shareholder basis	\$1,200,000	\$1,200,000
Add, S corporation income	\$952,381	\$0
Less, distribution to pay tax	\$(352,381)	\$0
Basis in the stock	\$1,800,000	\$1,200,000
Corporate assets, beginning	\$1,800,000	\$1,800,000
Income retained	\$600,000	\$600,000
Less, paid on debt	\$(600,000)	\$(600,000)
Corporate assets, ending	\$1,800,000	\$1,952,381
Shareholders deferred taxable gain	\$0	\$752,391

Assuming the S corporation is the debtor, as compared with the C corporation with debt, once the debt has been paid, the S corporation shareholder's basis in the stock will be increased by the amount of the debt that was retired, while the C corporation shareholder's basis in the stock will not change. When debt is used to acquire a portion of the stock, the cash flow from taxable income will be used to repay the debt and will not be available to the new owner of the stock. However, the S corporation shareholder will increase his or her basis in the stock as the debt is repaid, whereas the C corporation shareholder does not get any basis benefits from the corporation's income, as illustrated in Table 2.6.

As illustrated earlier, retaining the C corporation status rather than making an S corporation election is not tax efficient if the corporate tax rate is equal to or greater than the shareholder's tax rate. If the C corporation tax rate is lower than the shareholder's tax rate, retaining the C status may be tax efficient only if the stock will not be sold for several years so that the present value of the tax on the sale of the stock is very low.

Unwanted Assets

In many cases, the stock purchaser does not desire to retain all of the corporation's assets. The unwanted asset can raise the price of the stock, perhaps beyond the means of the acquirer. This problem can be solved by shareholders accepting a note payable from the corporation in exchange for a portion of their stock, as a temporary financing measure, with an agreement that the note will be paid out of the proceeds from the corporation's sale of the unwanted assets. The shareholder's gain will usually qualify for installment sale treatment, and thus, the gain will not be recognized until the note is paid. As discussed earlier, the note should be from the corporation rather than the new shareholder because the source of funds for paying the note will be the corporation's after-tax income and distributing the funds to the new shareholder to pay the note will usually result in dividend income to the shareholder.

Employment Agreements, Covenants to Not Compete, and Personal Goodwill

The selling shareholder may be a valuable resource whom the buyer wishes to retain for a period after the stock purchase. Thus, it may be prudent for the corporation and the former shareholder to enter into an employment contract. The former shareholder will earn ordinary income for services, and the corporation will have an ordinary and necessary expense.

When negotiating the purchase, an employment contract can become an important variable. The purchaser is willing to pay a certain amount to acquire the business, and the seller has an idea as to what he or she can expect from exiting the corporation. The

employment contract may be a part of the deal. Ideally, the buyer and seller would each like to be given a fixed amount to be allocated among various components of the acquisition. The purchaser would prefer to allocate as much as possible to the employment contract because it would be deductible over the relatively short life of the employment contract, while the payments for the stock or assets must be capitalized and amortized or depreciated over time. On the other hand, the seller would prefer allocating as much of the price to the stock and as little as possible to the employment contract in order to maximize the capital gain from the sale of the stock and minimize the ordinary compensation income. Thus, these parties with adverse interests must negotiate the final agreement.

As an employee, the former shareholder will not be able to compete with the employer. On the other hand, the former shareholder's services may not be needed, but the corporation should take steps to prevent the former shareholder from forming another business that could compete with the corporation he or she sold. A contract prohibiting the seller from competing with the corporation (a covenant to not compete) may be agreed upon by the former shareholder and the corporation. The contract is a self-created section 197 intangible of the corporation, whose cost must be amortized by the corporation over 15 years.¹² The former shareholder must recognize ordinary income from the covenant when the payments are received.¹³

The corporation would prefer that its payments to the former shareholder be characterized as current services to the corporation rather than as a covenant to not compete against the corporation. This is true because the payments for services can be expensed as the cost accrued under the contract (e.g., each year), whereas the

payments under the covenant must be amortized over 15 years. However, the timing benefits of the payments for services classification may be partially offset by the corporation's employment taxes on the compensation for services. The former shareholder should be indifferent to the characterization because the income is ordinary income when it is received under either classification. But the former shareholder must perform significant service for the employment classification to be upheld.

Personal Goodwill

In a few cases, a shareholder who is very active in the business has been able to separate his or her goodwill from the goodwill of the business.¹⁴ The shareholder's objective is to get payments from the purchaser classified as *personal goodwill*, which is eligible for capital gain treatment for the former shareholder and a capital expenditure for the corporation, rather than ordinary compensation for services, taxed as ordinary income and subject to social security or self-employment tax, but deductible by the corporation.

For example, assume that Dr. Bones has an incorporated practice, the Bone Clinic, P.C. While associates work with Dr. Bones, his reputation draws the referrals from other MDs, the primary source of patient revenues. The Bones Clinic was acquired by a much larger medical group. The purchaser acquired all the stock for cash and also paid Dr. Bones for his personal goodwill. As a part of the transactions, Dr. Bones retired from practice and did not enter into a covenant to not compete. On the basis of some court decisions, the payments labeled for personal goodwill would be recognized as such, and Dr. Bones, who has no basis in his personal goodwill, would treat the payments as capital gain. If Dr.

Bones did enter into a covenant to not compete but also received a payment for his personal goodwill, the IRS would argue that all of the payments were actually for the covenant. Thus, the absence of a covenant gives Dr. Bones the possibility of capital gain for the personal goodwill. The IRS would also argue that the goodwill resided in the clinic and not in Dr. Bones. Generally, it is an uphill battle to justify payments as for personal goodwill.

The parties may have some flexibility in allocating payments as for stock, for covenant to not compete, or for personal goodwill, but the allocations of prices must be reasonable. That being said, there may be a range of reasonable amounts placed in the various categories that become the subject of negotiations.

Summary

This chapter has discussed the initial decision whether to purchase stock or assets of a C corporation, and pricing the two alternatives. When the corporation's assets are appreciated, the tax laws favor a stock acquisition and present opportunities for the buyer and seller to share the tax benefits of the stock deal. Seller financing in the form of stock redemptions with the price paid in installments provides a means of resizing the transaction to fit the financial capacity of the buyer. Third-party debt may also be used, but generally the debt should be incurred by the target corporation, rather than by the buyer, so that the debt can be paid out of corporate earnings and without yielding taxable income to the purchaser. Issues with unwanted assets can be addressed at the time of the purchase in a manner in which the burden is shared by the buyer and seller.

Value may be removed from the stock price and treated as a

payment to the selling stockholder as a covenant to not compete, or for the seller's goodwill. The classifications of payments present some complex issues but possible benefits to one side of the transaction and a possible detriment to the other party (e.g., ordinary income to the seller but current deduction for the buyer).

1 In 2018–2022 the equipment may qualify for bonus depreciation, and therefore, the purchaser's cost would be immediately deductible; the $PV \times \text{tax rate}$ would be .21, the same as supplies.

The reduction on price would be less than the \$98,510 if, for example, the corporation's equipment had been used for 2 years, and thus, could be depreciated over two more years, and the building had only 10 years remaining on its depreciable life.

2 Section 543.

3 Section 531.

4 Section 331.

5 Section 301.

6 Section 1361.

7 Section 1375.

8 Section 1374.

9 (c) Qualified small business stock

For purposes of this section—

(1) In general

. . . the term “qualified small business stock” means any stock in a C corporation that is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if,

(A) as of the date of issuance, such corporation is a qualified small business, and

(B) except as provided in subsections (f) and (h), such stock is acquired by the taxpayer at its original issue (directly or through an underwriter)

(i) in exchange for money or other property (not including stock) or

(ii) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).

(2) Active business requirement, etc.

(A) In general,

stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer’s holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation. . . .

(d) Qualified small business

. . . means any domestic corporation that is a C corporation if

(A) the aggregate gross assets . . . do not exceed \$50,000,000
. . .

¹⁰ Section 172.

¹¹ Section 382.

¹² Section 197(c)(2).

¹³ Rev. Rul. 69-643, 1969-2 CB 10.

¹⁴ *Martin's Ice Cream v. Comm.*, 110 TC 189 (1998); *Norwalk*, T.C. Memo. 1998-279. *H&M, Inc* T.C. Memo. 2012-290; *Bross Trucking, Inc.*, T.C. Memo. 2014-107, and *Estate of Adell*, T.C. Memo. 2014-155.

CHAPTER 3

The Purchase and Sale of an S Corporation

The purchase and sale of an S corporation can be accomplished by either a purchase of the assets and liquidation of the corporation or simply a purchase and sale of the stock. These are the same options as are available for the purchase and sale of a C corporation. However, unlike the sale of the C corporation assets or stock, the double-tax on corporate gains is generally not an issue when the target is an S corporation. The major issues for the owners of the S business are the timing and character of the income, and the major issue for the purchaser is the basis obtained in the assets.

The Asset Sale versus the Stock Sale

A sale of S corporation stock without a liquidation of the corporation yields capital gain to the S shareholder—the same as for a C corporation shareholder. For both the C and S corporations, the new owner of the stock will not get the benefit of a step-up in basis for the corporation's assets without the corporation recognizing gain, which generally requires a sale of assets and liquidation. With the sale of assets and liquidation of a C corporation, the corporation is subject to tax on ordinary income and capital gains (taxed at the same rate), and the individual's

income from liquidation is all capital gain. On the other hand, the S corporation's income is not taxed at the corporate level; rather, the gains and losses realized by the corporation from sales in liquidation are ordinary or capital gain, depending upon their character (e.g., ordinary, capital, section 1231 gain) in the hands of the corporation. The gains and losses retain their character when they flow through to the shareholders.

In the simplest case of a single shareholder of an S corporation, a sale of the stock will result in capital gain, regardless of the character of the corporation's assets. The purchaser will have a cost basis in the stock, but the corporation's bases in its assets will not change. Consider the following example, shown in Table 3.1, of a target S corporation with appreciated assets.

Assume all of the corporation's liabilities have been paid, and the shareholder's basis in the stock is the same as the corporation's basis in its assets. The shareholder's basis was derived from a \$400,000 capital contribution and the corporation's retained income of \$380,000, which is the shareholder's previously taxed S corporation income. If the new owner paid \$1,800,000 for the stock, the former shareholder would have a \$1,020,000 capital gain. The corporation's basis in the individual properties would not change and the total corporate basis would remain at \$780,000. As discussed in the previous chapter, the tax savvy investor would not pay \$1,800,000 for the stock when the basis in the corporation's assets remains at \$780,000. In effect, the buyer of the stock would be purchasing a business and a potential tax liability for the differences between fair market values and bases. That is, if immediately after the purchase of the stock the corporation's assets were sold for \$1,800,000, the corporation would realize \$140,000 ordinary income (\$150,000 gain on

equipment and a \$10,000 loss on accounts receivable), \$300,000 gain (on the building) taxed at 25 percent, \$150,000 section 1231 gain (on land), and \$430,000 capital gain. This would flow through to the new shareholder as ordinary income, 25 percent gain and capital gain, assuming the S corporation election would continue. The shareholder's S income would increase his or her basis in the stock to \$1,800,000 (\$780,000 + \$1,020,000): thus the shareholder's basis in the stock will equate to the value of the assets sold, \$1,800,000. A result of selling the assets was that the \$140,000 ordinary income would flow through to the shareholder, rather than capital gain from the sale of the stock—the seller converted capital gain into ordinary income.

Table 3.1 Value, basis, and character of assets

	Appraised value of assets	Corporation's basis	Character of gain or loss from sale
Accounts receivable	\$70,000	\$80,000	Ordinary
Equipment	\$450,000	\$300,000	Ordinary
Building	\$600,000	\$300,000	Capital*
Land	\$250,000	\$100,000	Capital**
Secret formulas	\$130,000	\$0	Capital
Goodwill and going concern value	\$300,000	\$0	Capital
Total	\$1,800,000	\$780,000	

*The gain to the extent of prior depreciation would be taxed at not greater than 25 percent.

**The gain would be treated under section 1231 as a capital gain, provided the taxpayer's total section 1231 gains and losses from all sources results in a net gain.

Sale of Stock versus Sale of Assets

A sale of stock is much simpler to accomplish than a sale of assets and liquidation. However, as discussed earlier, in order for the new owner to get the benefits of a step-up in assets bases, the corporation must undergo either an actual sale of assets and liquidation or, as will be discussed further, a hypothetical liquidation as permitted by the regulations. The asset sale may

result in ordinary income for the S corporation shareholder. With a stock sale, the shareholder's entire gain is taxed at the capital gains tax rate. But the simplicity of a stock sale has its costs: When the corporation has appreciated assets, the buyer will not pay for the stock an amount equal to the fair market value of the assets, if the buyer is to retain the lower corporate basis. As in the case of a C corporation, discussed in the previous chapter, the buyer will reduce the price by the amount of the present value of the lost tax benefits of a fair market value basis. However, the trade-off between the seller's tax burden from a gain on the sale of assets and the buyer's benefits of a step-up is much different with the S corporation as compared with the S corporation shareholder.

With the C corporation, the shareholder's added burden from a sale of assets is equal to the corporate tax on the sale of the assets. In the earlier example, the tax on the total gain from the sale (assuming a 21 percent tax rate) of its assets would be 0.21 $(\$1,800,000 - \$780,000) = \$214,200$.

With the S corporation's sale of assets, the shareholder's added burden is merely the difference between the shareholder's ordinary (assumed to be 37 percent) and capital gains tax on the corporation's assets, which are not eligible for capital gains treatment. In the earlier example, the added tax burden of the S corporation's sale of its assets is the ordinary rather than capital gains tax on the equipment approximately and accounts receivable $(0.37 - 0.20)(\$140,000) = \$23,800$, and the additional tax on the building $(0.25 - 0.20)(\$300,000) = \$15,000$. The present value of the buyer's benefits from the \$1,020,000 step-up in basis in the example is \$98,510; thus, it cost the seller \$23,800 for the buyer to attain \$98,510 in tax benefits. Without the step-up, the buyer's price should be $\$1,800,000 - \$98,510 = \$1,701,490$. Thus, in this

example, the form of the transaction should be as a sale of assets.

	Assets	Stock
Selling price of assets, stock	\$1,800,000	\$1,701,490
Less, basis	\$(780,000)	\$(780,000)
Gain on sale	\$1,020,000	\$921,490
Ordinary income tax ($0.37 \times \$140,000$)	\$(51,800)	
Tax on building, ($0.25 \times \$300,000$)	\$(75,000)	
Capital gains tax ($0.20 \times \$580,000$), ($.20 \times \$921,490$)	\$(116,000)	\$(184,298)
After-tax proceeds to seller	\$1,557,200	\$1,517,192

Because of the recovery period for the assets that produce ordinary income, the seller's detriment from realizing ordinary income from a sale of assets is generally far less than the buyer's tax benefits from stepping up the basis in assets purchased. The ordinary income property is generally assets with a relatively short cost recovery period (e.g., inventory and equipment). The shareholder's benefit from capital gains attributable to these assets is only the tax differential of 17 to 22 percent. On the other hand, the buyer's tax benefit from the short recovery period is generally much greater. For example, with a five-year cost recovery period, a 10 percent rate of return, and a 37 percent tax rate, the present value of tax benefits from an asset basis increase is 29 percent of the change in basis (see Chapter 1). Thus, with appreciated assets, generally an asset sale will yield the greater after-tax proceeds for the seller.

Moreover, the assets with the long recovery period for the buyer (e.g., buildings and intangibles) will be eligible for the capital gains rates for the seller. Thus, for these assets, there will be no cost to the seller for an asset sale as compared with a stock sale, but the buyer will enjoy substantial benefits from the asset

purchase.

Shareholder Purchased Stock for More than Book Value

One situation where the sale of stock may be preferable is when the shareholder's basis in the stock is much greater than the book value of the S corporation equity. This could happen when the S corporation shareholder purchased the stock of the corporation for more than its book value and later sold the stock. For example, if the shareholder in the earlier example had a basis in the stock of \$1,500,000, when the corporation's basis in the assets was \$780,000, the sale of the stock would yield the greater after-tax proceeds to the shareholder.

	Assets	Stock
Selling price of assets, stock	\$1,800,000	\$1,701,490
Less, basis	\$(780,000)	\$(1,500,000)
Gain on sale	\$1,020,000	\$201,490
Ordinary income tax ($0.37 \times \$140,000$)	\$(51,800)	
Building ($0.25 \times \$300,000$)	\$(75,000)	
Capital gains tax ($0.20 \times \$580,000$), ($.20 \times \$201,490$)	\$(116,000)	\$(40,298)
After-tax proceeds to seller	\$1,557,200	\$1,661,192

But this is not all to the story. This shareholder in the S corporation, which sold its assets, will increase his or her original basis in the S stock by the \$1,020,000 gain from the assets to equal $(\$1,500,000 + \$1,020,000) = \$2,520,000$. When the corporation distributes \$1,800,000 in liquidation, the shareholder will have a \$720,000 capital loss (which can only be used to offset capital gains and then ordinary income for \$3,000 per year). Such a sizable capital loss could remain largely unused.

Another alternative to the corporation's sale of assets followed by

liquidation would be to distribute the assets to the S corporation shareholder in liquidation and the shareholder would sell the assets. The S corporation would be required to recognize a \$1,020,000 gain on the liquidating distributions and the gains and losses would flow through to the shareholder, the income retaining its character (ordinary and capital) as though the corporation sold its assets. The total \$1,020,000 income would increase the shareholder's basis in the stock. Again, the shareholder would be left with a large and probably unusable capital loss.

The Hypothetical Sale of Assets

Generally, a change in ownership of the assets is required for a step-up in asset bases. When the assets are owned by a corporation, the assets would have to be either distributed or sold for the new owner to gain a fair market value basis. The distributions could result in substantial transaction costs (e.g., changing titles). Moreover, the changes in ownership could affect preexisting contracts. The regulations provide an elective means for avoiding these costs: The regulations permit treating the sale during a 12-month period of a controlling interest (80 percent or more) in an S corporation stock as though the corporation sold its assets and the new owner transferred the assets back to the corporation in exchange for the stock.¹ Under the regulations, the corporation recognizes the hypothetical gains and losses from the deemed sale of the assets, and those gains and losses flow to the shareholders, who are treated as surrendering their stock after its basis has been increased by the deemed sale of the assets. The corporation restates its bases in assets to equal their fair market value. Thus, the shareholders are able to receive for their stock a value based on the fair market value of the corporation's assets.

The election is available if at least 80 percent of the target corporation's outstanding stock is sold or exchanged in a 12-month period²—a *qualified purchase*. The election must be jointly made between and among all the S corporation shareholders and the corporate purchaser who acquires control.³ However, when control is not acquired by a single corporation, the election is made solely by all the shareholders in the selling corporation. As mentioned earlier, the election can be made even though only 80 percent of the stock is sold, but the nonselling shareholders must consent to treating the stock sale as an asset sale. The nonselling shareholders' consent is required because they must pay tax on their share of the gain from the hypothetical sale of the corporation's assets. It should be expected that the nonselling shareholders will require compensation for making the election.⁴

The election must be made by the 15th day of the ninth month beginning after the month in which the 80 percent threshold is reached. Complying with election requirements is extremely important, especially for the purchaser. If the election is invalid, once the corporation acquires the stock, the S corporation status is terminated because an S corporation cannot have a corporate shareholder. Moreover, the corporation's year is terminated and the corporation must file as a C corporation for the remainder of the year, and the purchaser will not enjoy a step-up in basis without liquidating the corporation. On the other hand, an invalid election may enable the selling shareholder to convert ordinary income from a deemed sale of the corporation's ordinary income property into capital gain from the sale of the stock.

Installment Sale

The installment sale, whereby the seller receives payments for

property in more than one tax year, is a means for the seller to defer gain until the purchase price is collected. For the purchaser, the transaction is treated as a debt-financed acquisition; that is, the purchaser includes the amount owed on the installment contract as a part of the cost of the asset. Thus, the buyer can increase basis before the seller recognizes the gain.

In the S corporation transactions presently being discussed, the installment sale could be for either (1) the shareholder's sale of the stock or (2) the corporation's sale of its assets. Very different results follow from the two options. The installment sale of the stock is the simpler of the two options.

Installment Sale of the Stock

When the shareholder sells the stock for consideration that will be received in a year subsequent to the year of the sale, the shareholder's gain from the sale of S corporation stock is capital gain, which is computed each year using the installment sales formula.

$$(\text{Gain/Contract Price}) \times \text{Collections on principal received during the tax year}$$

The installment contract must bear interest at least equal to the federal interest rate. If the contract does not provide adequate interest (interest at least equal to the applicable federal interest rate), the price will be recomputed as though it included this interest.⁵ The effect of computing the interest is to reduce the contract price and reclassify part of the payments to be received as interest income, thereby reducing the seller's capital gain. Thus, all of the income recognized by the seller from selling the stock is either capital gain or interest income, and the income is spread

over the life of the contract.

However, as discussed earlier, if the new owner purchases stock, the corporation's bases in its assets generally do not change. Thus, if the corporation has appreciated assets, the buyer will discount the price to the seller, just as in the case of the purchase of C corporation stock. As was discussed earlier, a special election may be available, which permits a corporate purchaser of the stock to adjust the basis in the target corporation's assets.

Installment Sale of the Assets

When the business is transferred to the new owners by means of a sale of the S corporation's assets, rather than a stock transaction, the installment method becomes more complex. This is due to the fact that certain assets are not eligible for installment sales reporting. Only property sold at a profit is eligible for the installment method. Gains from inventory and the recapture of depreciation on tangible personal property are the most frequently encountered gains that cannot be reported by the installment method.

	Appraised value of assets	Corporation's basis	Built-in gain (loss)	Character of gain or loss from sale
Accounts receivable	\$70,000	\$80,000	(\$10,000)	Ordinary
Equipment	\$450,000	\$300,000	\$150,000	Ordinary
Building	\$600,000	\$300,000	\$300,000	Capital*
Land	\$250,000	\$10,000	\$150,000	Capital**
Secret formulas	\$130,000	\$0	\$130,000	Capital
Goodwill and going concern value	\$300,000	\$0	\$300,000	Capital
Total	\$1,800,000	\$780,000	\$1,020,000	

*25 percent maximum tax rate

**Net section 1231 gain treated as capital gain

The previous chapter addressing the sale of C corporation assets contains an example of a sale of the assets for \$1,200,000 cash and an interest bearing note for \$600,000. The cash sale could be partitioned into \$520,000 cash for the accounts receivable and equipment, property that is not eligible for the installment method, and a \$140,000 gain would be recognized. Thus, the installment variables are as follows:

	Appraised value of assets	Corporation's basis	Built-in gain (loss)	Character of gain or loss from sale
Accounts receivable	\$70,000	\$80,000	(\$10,000)	Ordinary
Equipment	\$450,000	\$300,000	\$150,000	Ordinary
Building	\$600,000	\$300,000	\$300,000	Capital*
Land	\$250,000	\$10,000	\$150,000	Capital**
Secret formulas	\$130,000	\$0	\$130,000	Capital
Goodwill and going concern value	\$300,000	\$0	\$300,000	Capital
Total	\$1,800,000	\$780,000	\$1,020,000	

*25 percent maximum tax rate
**Net section 1231 gain treated as capital gain

The installment sale gain would be partitioned into capital gain, 25 percent gain on the building, and section 1231 gain on the land.

The Hypothetical Sale of Assets under the Installment Method

When at least 80 percent of the S corporation stock is being sold, all of the shareholders (including shareholders who are not selling their stock) can elect to treat a sale of stock as a sale of the S corporation's assets, as discussed earlier. Moreover, if payments for the stock will be received after the tax year of the sale, the gain can be reported by the installment method. The corporation immediately adjusts its bases in assets to their fair market values in the year of the sale (as determined by the price of the stock),

but the shareholders report their gains in the years the collections are received. From the shareholder's point of view, the difference between the sale of the stock with this election and without the election is that with the election the shareholder's gain is partitioned among the different types of gains (ordinary, capital, 25 percent, section 1231), the same as an actual installment sale of the assets. Thus, the purchaser of the stock under the election gets the benefits of an immediate adjustment to bases in assets, while the shareholder can defer a portion of his or her gain. Because of the ability of the buyer to step up basis in the assets, the price of the stock should be greater with the election as compared with a sale without the election, but the price difference may be absorbed by converting capital gain into ordinary income from the inventory and depreciable equipment.

The regulations contain an interesting example of a hypothetical sale of assets on the installment method, with more than one shareholder, and only one receives deferred payments.⁶ The example is simplified in that all of the assets are eligible for installment reporting, and none of the gain is ordinary income. In the example, shareholders A and B each own 40 percent of the S corporation stock and C owns 20 percent. A and B sold their stock, but C did not. Because A and B sold a total of 80 percent of the stock, the election to treat the transactions as a sale of the assets was available. The facts are summarized in the following table.

Shareholders	% of Stock	Basis in stock	Consideration received for stock		
			FMV of stock	Cash	Installment note
A	40%	\$10,000	\$40,000	\$40,000	
B	40%	\$10,000	\$40,000	\$15,000	\$25,000
C	20%	\$5,000	\$20,000	n/a	n/a

The corporation’s total basis in its assets was \$35,000, their total fair market value was \$110,000, and the corporation’s liabilities totaled \$10,000. All of the shareholders consented to the hypothetical asset sale treatment. It should be noted that although C did not sell his stock, the corporation is deemed to sell all of the assets. The total price of the assets is equal to the grossed-up price paid by A and B plus the amount of the corporation’s liabilities.

Grossed-up price of stock = (\$40,000 + \$15,000 + \$25,000)/100%/80% =	\$100,000
Liabilities	\$10,000
Total price	\$110,000
Less, corporation basis in assets	(\$35,000)
S Corporation total gain	\$75,000

Total gain will be allocated to the shareholders on the basis of their percentage ownership of the stock.

Shareholders	% of Stock	Allocation of Gain
A	40%	\$30,000
B	40%	\$30,000
C	20%	\$15,000
		\$75,000

Note that \$15,000 gain is allocated to C even though he did not sell his stock. Because he is forced to pay tax on a portion of the gain, C is required to consent to the election to apply the hypothetical sale of assets approach. Moreover, he would likely expect to be compensated for making the election.

Because the sale involved a deferred payment, the next step is to determine how to allocate the installment sale gain. Because A received all cash, all of his gain is recognized in the year of the sale. C’s gain must also be recognized at the same time. However, B received the installment obligation, and thus, a portion of his

gain is deferred using the installment sale formula: $(\text{Gain}/\text{Contract Price}) \times \text{Collections}$.

This is first computed at the corporate level. The corporation sold the assets for a \$75,000 gain, and the contract was \$110,000 – \$10,000 liabilities = \$100,000. Thus, the installment sale gross profit ratio is $\$75,000/\$100,000 = 0.75$.

The corporation is deemed to have collected in the year of sale the contract price, $\$100,000 - \$25,000 \text{ note} = \$75,000$. Thus, the corporation's gain in the year of sale is $0.75 \times \$75,000 = \$56,250$. This gain flows through to A and B, $0.40 \times \$56,250 = \$22,500$, each. A's basis in the stock is increased to $\$10,000 + \$22,500 = \$32,500$. As a part of the hypothetical sale, the corporation is deemed to have been liquidated and A's liquidation proceeds were $0.40 \times \$100,000 = \$40,000$. Therefore, A recognizes \$22,500 gain from the corporation's sale of assets and $\$40,000 - \$32,500 = \$7,500$ gain from liquidation of the corporation. B received an installment note, and in addition to the \$22,500 gain from the corporation's deemed sales, A must recognize gain from the \$15,000 cash received in the year of sale. B's basis in the stock increased to \$32,500 as a result of the corporation's gain, and his total consideration is \$15,000 in the year of sale and \$25,000 deferred payment. B's contract price becomes $\$15,000 + \$25,000 = \$40,000$, and his deferred gain is the total gain $(\$40,000 - \$10,000) \$30,000 - \$22,500 = \$7,500$, which is recognized as the contract price collected.

Gain in the year of sale = $\$15,000 \times \$7,500/\$40,000 =$	\$2,812
Gain when the note is collected = $\$25,000 \times \$7,500/\$40,000 =$	\$4,688
Gain from deemed corporate sale and liquidation =	<u>\$22,500</u>
Total gain	<u>\$30,000</u>

Purchase of a Minority Interest in an S Corporation

The purchase of a noncontrolling interest in an S corporation for more or less than the book value of the stock does not result in any adjustments to the corporation's basis in its assets. Unlike the purchase of an interest in an LLC (discussed in Chapter 1), the law does not permit the corporation to adjust the basis in its assets with respect to the new owner. Therefore, if the corporation has built-in gain (fair market value of the assets exceeds their bases), the buyer generally should not pay for the stock an amount equal to the fair market value of the assets. The price must be discounted for the missing tax benefits of the corporation's assets equal to their fair market value.

Summary

The S corporation shareholder's income from the sale of the corporation's assets will derive its character (e.g., ordinary, 25 percent, section 1231, capital) from the corporation, while the gain from the sale of the stock is entirely capital gain. However, with the stock sale the buyer will not obtain a new basis in the assets, and thus, the buyer must discount the price of the stock for the loss of tax benefits. Whether the reduction in price the seller receives is equal to the tax benefits from the all capital gains treatment on the sale of the stock depends upon the amount of the step-up in basis, the proportion of the gain on the sale of the assets that will be taxed as ordinary income, the difference between the ordinary and capital gains rate, and the difference between the seller's basis in the stock and the book value of the equity (corporation's basis in assets less the corporation's liabilities). Finally, either the assets or the stock can be structured as an installment sale, and an installment sale of the stock can also be

treated as an installment sale of the assets. Thus, it is necessary to *do the numbers* for the various alternatives.

¹ Reg. §1.338(h)(10), and Section 336(e).

² Section 338(d)(3).

³ Section 338(h)(10).

⁴ Reg. §1.338(h)(10)-1(c)(3).

⁵ Section 1274.

⁶ Reg. §1.338(h)(10)-1(e)Example 10.

CHAPTER 4

The Purchase of a Corporation's Subsidiary

Larger corporations often have subsidiaries. Conditions change and a subsidiary is put up for sale. Often some of the employees are the market for the stock. A corporation's sale of its subsidiary brings into play some unique provisions in the tax laws that are intended to prevent triple taxation of the income from the subsidiary. The same income earned by a corporation is often subject to tax by three different taxpayers, or groups of taxpayers. For example, assume X corporation transferred \$1,000 cash to its newly formed subsidiary, Y corporation, for all of its outstanding stock. Further, assume Y used the cash to purchase a single asset that increased in value to \$1,500 when X sold the Y stock for \$1,500. X realized an economic and taxable gain of $\$1,500 - \$1,000 = \$500$. Because X had an economic gain of \$500, the X shareholders should have an additional \$500 gain when they sell their stock or receive dividends from Y; Y will also have a \$500 gain when it sells its assets. The general scheme of double taxation of corporate income was violated in this example.

Economic gain = $\$1,500 - \$1,000 =$	\$500
Parent taxable income =	\$500
Subsidiary gains (asset values less basis) =	\$500
Parent shareholder's gain to be realized in the future =	\$500

The purchaser of the Y stock will mitigate some of the double taxation effects by reducing the price of the stock for the tax on the \$500 built-in gain that will be realized when the assets are sold. Nevertheless, where the parent's basis in the subsidiary stock is less than the value of the subsidiary's net assets, triple taxation often occurs.

The IRC provides methods for avoiding the triple taxation in some situations. The third tax can be avoided by utilizing the dividend-received deduction. That is, if the parent owns at least 80 percent of the subsidiary's stock, a dividend from the subsidiary to the parent is not taxable income to the parent. In the earlier example, Y could have sold its appreciated assets and distributed the proceeds to the parent, who could utilize the dividend-received deduction. As another means of avoiding triple taxation, the parent and subsidiary can file consolidated returns, which permit the parent to increase its basis in its subsidiary stock as the subsidiary recognizes its income from the sale of the asset. The increase in basis prevents the parent from recognizing the subsidiary's income a second time when the stock in the subsidiary is sold. However, the dividend-received deduction and consolidated return rules do not prevent the parent from recognizing gain on the sale of the subsidiary stock when the subsidiary has appreciated assets at the time the parent sells the stock. The Code does permit the parent corporation to liquidate the subsidiary and neither the parent nor the subsidiary is required to recognize gain. Instead, the parent assumes the subsidiary's basis in the assets, and the parent can sell the assets and realize the same gain the subsidiary would have recognized, had the subsidiary sold the assets. However, an actual liquidation of the subsidiary will necessitate administrative costs, could violate contracts, or destroy contractual arrangements.

The Code also provides a means to avoid triple taxation of corporate income without the complexities of an actual liquidation of the subsidiary: When the parent sells at least 80 percent interest in the subsidiary, the parent and the buyer of the subsidiary stock can elect to treat a purchase and sale of stock as a purchase and sale of the corporation's underlying assets. These rules were discussed in the previous chapter in the context of a purchase and sale of S corporation stock. If the election is made, the parent's realized gain on the sale of the stock is not recognized, but the subsidiary must recognize gains and losses as though it had sold its assets, and the subsidiary's bases in its assets are restated to approximately their fair market value; thus, double, but not triple, taxation is the result.

Economic gain = \$1,500 - \$1,000 =	\$500
Parent taxable income =	\$500
Subsidiary income to be realized in the future =	\$500
will P shareholder's gain to be realized in the future =	\$500

The provisions in the law that permit the parent to sell the stock without recognizing gain took on added significance in 1993, when the IRC was amended to permit the general amortization of intangibles acquired with the business. The purchase of the stock is treated as a purchase of the assets of a business; therefore, the purchase price is allocated among the target corporation's assets (including the corporation's goodwill and other intangibles) and becomes the target's new total basis in its assets. The ability to amortize the intangibles creates financial value that did not previously exist, as illustrated here.

A parent corporation formed a subsidiary to create a patent. The cost of developing the patent was deducted as a research and development expense on the consolidated return of the

parent and subsidiary (e.g., the subsidiary's loss reduced the parent's taxable income). The subsidiary's basis in the patent was zero, but the patent is expected to produce a stream of future income of \$1,000,000 per year for many years. The parent does not have the ability to exploit the patent, and a larger corporation has offered to buy the stock of the subsidiary for \$3,000,000.

The stock sale would result in a \$3,000,000 gain for the parent, a $0.21(\$3,000,000) = \$630,000$ tax liability, and \$2,370,000 after-tax proceeds. The new owner of the stock, generally, would then have control of a corporation with no basis in assets, and thus, no deductions for the cost of the patent. But if the selling parent and the purchaser agree to a joint election to treat the sale of the stock as a sale of assets, the price should change to reflect the present value of the future tax deductions for the amortization of the patent. As discussed earlier in these materials, assuming a 10 percent rate of return and a 21 percent marginal tax rate, the present value of the amortization of an intangible asset is approximately 10.7 percent of its cost. Therefore, a price of \$3,250,000 and an amortizable basis in the patent would be of approximately the same value on an after-tax basis as a price of \$3,000,000 without amortization; that is, $\$3,600,000/1.107 = \$3,250,000$. As summarized further, the parent corporation would realize an additional \$197,500 ($\$250,000 \times (1 - 0.21)$) in after-tax proceeds by making the election to treat the sale of the stock as a sale of assets. On the other hand, the buyer should be indifferent between the purchase of the stock without the election for \$3,000,000 and the purchase of the stock for \$3,250,000 with the election. This is true because by paying the additional \$250,000 and

making the election, the buyer gets the benefit of amortizing \$3,250,000; that is, \$3,250,000 paid but available as an amortization deduction has the same after-tax value as \$3,000,000 paid but no amortization deduction.

Thus, the buyer will pay \$3,250,000 for the stock. After paying the \$682,500 subsidiary's tax on the deemed sale of the assets ($0.21 \times \$3,250,000$), the parent is left with net proceeds of \$2,567,500.

The preceding example and Table 4.1 illustrate how the parent can obtain an additional 8.3 percent in after-tax proceeds ($\$197,500/\$2,370,000$) as a result of the election to treat the stock sale as an asset sale, while the buyer enjoys the same after-tax benefits under either option. However, the buyer must pay an additional \$250,000 under the option that benefits the parent selling the stock. Moreover, the buyer must agree to the election; that is, the election must be jointly made. Therefore, the purchaser has some bargaining power with the parent, and the purchaser would demand a share of the parent's benefits (\$197,500 in the example). The purchaser could realistically demand that the price be reduced to \$2,900,000 in exchange for making the election. But reducing the price of the stock to \$2,900,000 still means the buyer must provide an additional \$150,000 to close the deal.

Table 4.1 Calculating the parent's after-tax proceeds

		Parent	Value to the purchaser
Value of subassets without the election	\$3,000,000		
Sub's basis in assets	\$0		
Built-in gain	\$3,000,000		
Tax on built-in gain @ 0.21	\$(630,000)		
Sale of stock, without election			
Proceeds		\$3,000,000	\$3,000,000
Less tax @ 0.21		\$(630,000)	
Net to parent, without election		\$2,370,000	
Sale of stock, with election			
Price without amortization	\$3,000,000		
Add value of amortization	\$250,000		\$250,000
	\$3,250,000		\$3,250,000
Less, subtax @ 0.21	\$(682,500)		
Net to parent		\$2,567,500	
Increase to parent		\$197,500	

As shown in Table 4.2 the purchaser would pay the \$2,124,000 to be retained by the seller and \$1,176,000 subsidiary tax, for a total of \$3,360,000. The buyer's benefit from the negotiations and the election is \$200,000, and the seller's benefit is \$164,000.

Table 4.2 Calculating the parent's after-tax proceeds

		Parent	Value to the purchaser
Value of subassets without the election	\$2,900,000		
Sub's basis in assets	\$0		
Built-in gain	\$2,900,000		
Tax on built-in gain @ 0.21	\$(609,000)		
Sale of stock, without election			
Proceeds		\$2,900,000	\$3,000,000
Less tax @ 0.21		\$(609,000)	
Net to parent, without election		\$2,291,000	
Sale of stock, with election			
Price without amortization	\$2,900,000		
Add value of amortization	\$250,000		\$250,000
	\$3,150,000		\$3,250,000
Less, subtax @ 0.21	\$(661,500)		
Net to parent		\$2,488,500	
Increase to parent		\$197,500	

An installment sale may be a means to close the gap in the cash requirement: The buyer could pay \$3,000,000 cash and an installment note for \$250,000 with interest at the federal rate. The subsidiary's basis in the assets would be \$3,250,000, even though the buyer had only paid \$3,000,000 in cash—the installment note given is included in the price, and therefore, is included in the subsidiary's new basis in its assets. The parent who is selling the stock must recognize the \$250,000 gain when the buyer pays the notes. The tax - benefits of amortizing the \$3,360,000 for only a few years will provide sufficient cash flow to retire the \$360,000 debt. The annual benefits are $(\$3,250,000/15 \text{ years}) \times 0.21 = \$45,500$. Thus, within 6 years the principal and interest would be paid from the tax benefits of amortization.

In the previous example, the purchaser was a corporation. However, the same results can be achieved when a group of individuals, a partnership, or an LLC purchases at least 80 percent of another corporation's subsidiary in a 12 month period.

The Complications of Liabilities

The price of the target's assets will equal the cash consideration and the target's liabilities, including the target's tax on the hypothetical sale of its asset. That is, the assets are being restated to equal the value of the target corporation's equity and its liabilities. Generally, the total basis in the assets is termed the aggregate grossed-up basis (AGUB) and must be derived from the following equation:

$$AGUB = P + L + T,$$

where P = the grossed-up price of the stock

L = the target's liabilities recognized other than the tax on the hypothetical sale of its assets

T = the target's tax on the hypothetical sale of its assets

AGUB is also an approximation of the total purchase price of the assets (termed aggregate deemed selling price or ADSP in the regulations).

P is the price actually paid if the purchaser acquires 100 percent of the target stock. However, the election can be made if as little as 80 percent of the stock is acquired in the 12-month period. The objective is to arrive at the value of the entire equity; therefore, to approximate the total value, the amount paid for the actual purchases must be divided by that percentage. Thus, if 80 percent of the stock were purchased for \$100, P would equal $\$100/0.80 = \125 . Other adjustments are required when some of the stock was acquired before the 12-month period. The corporation's liabilities, L, are those recognized under the tax accounting principles of all vents and economic performance. The tax on the hypothetical sale, T, must be derived from the marginal tax rate of the target corporation and the gain on the deemed sale.

Example: Assume 80 percent of the target stock was acquired for \$2,400,000 when the target had \$260,000 in liabilities, the target's marginal tax rate was 21 percent, and the target's basis in the assets was \$400,000. The buyer pays \$2,400,000, and in effect, assumes 80 percent of the subsidiary's liabilities (\$260,000 plus the subsidiary's tax on the deemed sale).

$$\text{AGUB} = \$2,400,000/0.80 + \$260,000 + 0.21(\text{AGUB} - \$400,000)$$

$$\text{AGUB} = \$3,000,000 + \$260,000 + 0.21\text{AGUB} - \$84,000$$

$$0.79 \text{ AGUB} = \$3,176,000$$

$$\text{AGUB} = \$4,020,250$$

The tax on the subsidiary's deemed sale of its assets is 0.21 (\$4,020,250 - \$400,000) = \$760,250.

Therefore, in effect, the purchaser is paying for its 80 percent interest in the assets

$$\$2,400,000 + 0.80(\$760,250 + \$260,000) = \$2,400,000 + \$816,200 = \$3,216,200$$

or

$$0.80(\$4,020,250) = \$3,216,200.$$

To simplify the analyses, assume the purchaser acquired 100 percent of the stock for \$3,000,000, the grossed-up price of the 80 percent. The purchaser would have 100 percent ownership of a corporation with assets with a basis and value of \$4,020,250 and liabilities of \$1,020,250 (\$760,250 tax on the hypothetical sale plus \$260,000 other assets), or book value of \$3,000,000.

When Should the Election Be Made?

The election to treat a stock sale and purchase as a sale and

purchase of assets is best suited for a situation where the parent corporation's basis in the stock of the subsidiary is equal to the subsidiary's basis in its assets less the subsidiary's liabilities, but the fair market values of the assets have appreciated. This would be the case where the parent creates a subsidiary by transferring assets to the subsidiary whose bases are equal to their fair market value, and the parent and subsidiary file consolidated returns. Under these conditions, when the parent sells the stock and there is a deemed sale of assets, the parent's gain on the sale of the stock should equal the gain the subsidiary would have recognized from a sale of its assets. Therefore, under the election, the tax that the parent would pay on the sale of the stock, if the election were not made, will equal the subsidiary's gain on the deemed sale of its assets. Then the gain the sale of the assets will equal the parent's gain that is not recognized. Therefore, the subsidiary will pay a tax, the same as the parent would have paid, and the subsidiary's basis in its assets will be restated to their fair market value. On the other hand, if the parent purchased a subsidiary and paid more than book value for the stock, the election may not be beneficial.

The key to understanding when the election is beneficial to the seller is to recognize that the election substitutes as taxable gain the subsidiary's built-in gain (i.e., the excess of the value of the subsidiary's assets over their bases) for the parent's realized gain. If the parent's realized gain is less than the subsidiary's built-in gain, the election renders nontaxable the smaller gain.

Extending the previous example, where the fair market value of the assets was \$4,020,250, their total basis was \$400,000, and the parent's basis in the stock was \$2,500,000. The parent's basis in the stock was greater than its book value because the parent

purchased the stock in the subsidiary after it had been in operation for several years, and the amount the parent paid for the stock was greater than the book value of the target's equity (book value of assets less liabilities). The subsidiary's liabilities at the time of the purchase totaled \$260,000. To simplify the analyses, assume the parent purchased 100 percent of the stock. Further, assume that all of the appreciation is for intangible assets subject to 15-year amortization. Without the election, the purchase price of the stock would be the \$400,000 book value plus the \$4,400,000 value of other assets minus a reduction in price for the lack of amortization deductions (recall \$0.1073 is the value of \$1 of amortization over 15 years, with a 10 percent discount factor and a 21 percent tax rate), less the liabilities assumed.

Value of assets without amortization = \$400,000 +	
$\$4,400,000 \times (1 - 0.1073) =$	\$4,236,960
Less, liabilities	(\$260,000)
Price of the stock with no election	\$3,976,960
Less, parent's basis	\$2,500,000
Parent taxable gain	\$1,476,960
Tax @ 0.21 =	(\$310,162)
Net to parent	\$3,666,798

In the previous example, the price of 100 percent of the stock under the election was only \$3,000,000, which would be the parent's after-tax proceeds under the election. Therefore, the election would cost the parent \$666,798. This is primarily due to the fact that the parent has a much higher basis in its stock than the subsidiary's basis in its assets less its liabilities.

As a practical matter, the parties should *do the numbers* to compare the results to the buyer and seller with and without the election.

CHAPTER 5

Tax-Deferred Acquisitions of C Corporations

IRC provides for tax-deferred combinations of corporations through exchanges of stock or assets in the target corporation for stock in the acquiring corporation.¹ In some situations, the corporations and shareholders have a choice between taxable and tax-deferred transactions. Except where the situation is one of a merger of equals, the dominant party must heavily weigh the basis implications: If the target has appreciated assets, no step-up in basis is permitted in a tax-deferred acquisition of stocks or assets. From the perspective of the target corporation's shareholders, cash may be preferable—even though tax may be due—unless the stock of the acquiring corporation is highly liquid (e.g., the acquiring corporation is publicly held), and the target corporation's shareholders have faith in the future of the acquiring company, or the target corporation's owners intend to have an active role in the combined businesses. For example, assume Joe, the sole shareholder in Joe's construction company, is ready to retire when Moe, the sole shareholder in Moe's construction company, offers to exchange Moe stock for Joe stock. The offer would probably not be appealing to Joe, whose mind is on financing his retirement. On the other hand, if Joe and Moe can gain efficiencies by combining the companies, and Joe can be actively involved so as to protect his investment, a combination

through the exchange of stock may be a good business move accomplished in a tax efficient manner.

IRC2 describes the types of transactions, referred to as corporate reorganizations, which may be used to combine corporations in a manner that is tax deferred to the corporations and their shareholders. IRC specifies six forms the corporate reorganizations may take. In one of the forms available, merger, a corporation may acquire the assets and liabilities of another corporation (the target), and the target shareholders surrender their stock in exchange for the acquiring corporation's stock. In another form of reorganization, the shareholders in one corporation exchange their stock for stock in the acquiring corporation, but the target's assets are not transferred—the target becomes a subsidiary of the acquiring corporation. If the requirements for a reorganization are satisfied,

- the shareholders' realized gain is recognized only to the extent of the value of property received other than stock;
- the shareholders' basis in the stock surrendered becomes his or her basis in the stock received;
- neither the target nor the acquiring corporation recognizes gain or loss; and
- the target corporation's bases in its assets are unchanged.

On the other hand, in a taxable acquisition of assets, the acquiring corporation generally enjoys a fair market value basis in the assets received while the target shareholders recognize gain and attain a

fair market value basis in the stock and other property they receive.

The transactions must fit the patterns set forth in IRC to qualify for tax-deferred treatment, but, in addition, the corporations and the shareholders must satisfy certain doctrines:

- The transactions must have a business purpose.
- The corporations must satisfy a continuity of business requirement.
- The shareholders must satisfy a continuity of interest requirement.³

The business purpose requirement is usually not an issue for a well-managed company attempting to expand or improve its business. Business purpose can be an issue for closely held corporations that may undergo transactions primarily for the benefit of the shareholders, rather than to benefit the corporation. The continuity of business requirement simply means that a significant portion of the target corporation's historic business assets must be used in trade or business activities after the reorganization.⁴ Thus, a corporation that has sold all of its assets and is primarily holding cash could not be the target for a reorganization; however, according to the regulations, the continuity of business requirement is satisfied when as little as one-third of the target's historic assets are used in the business following the reorganization. Treasury regulations provide guidance regarding the continuity of interest requirement,⁵ as will be discussed later.

The Statutory Patterns

Descriptions of the types of tax-deferred reorganizations are set forth in sections 368(a)(1)(A) through 368(a)(1)(G). In the vernacular of IRC, the transactions that are described in section 368(a)(1)(A) are referred to as an *A reorganization*, and likewise for B through G reorganizations. These materials will address A, B, and C acquisitive reorganizations.

The A Reorganization

An A reorganization is defined as a *statutory merger, or consolidation*. Generally, the parties must satisfy relevant state laws to be treated as a merger (one corporation absorbed by another corporation) or a consolidation (two corporations combine into a third corporation). Once state laws have been satisfied, it is necessary to determine whether the business purpose and continuity of interest requirements are satisfied.

The A reorganization is depicted in Figure 5.1. Note that, generally, Target Corporation will liquidate after transferring all of its assets to Acquire Corporation, and the former shareholders of Target become shareholders in Acquire Corporation. The consideration given by Acquire can be a combination of cash and other property. The continuity of interest requirement for the A reorganization is determined by the consideration given by the acquiring corporation—at least 40 percent of the consideration must be stock in the acquiring corporation. Applying this objective test is sometimes difficult because of issues regarding which transactions are considered.

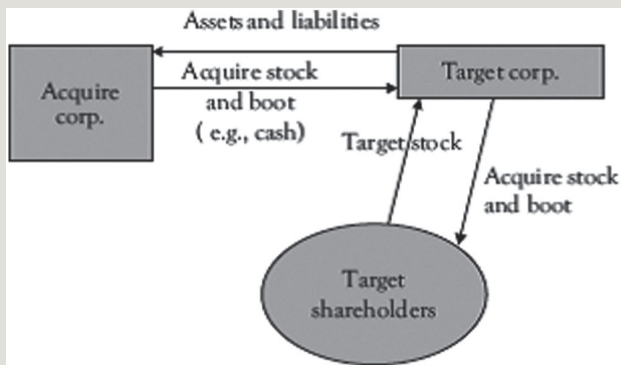


Figure 5.1 The A reorganization—statutory merger

For example, assume Acquire Corporation purchased 30 percent of the Target Corporation's stock for \$300,000 in year one, and 6 years later received the remaining 70 percent of the target stock from an individual in exchange for \$350,000 cash and Acquire stock with a value of \$350,000. The 70 percent shareholder's basis in the stock was \$200,000, and Target Corporation's basis in its assets was \$250,000. The shareholders who received only cash must recognize gain or loss for the difference between their basis in the target stock and the cash received, the same as any other sale of stock. The 70 percent target shareholder who received a combination of cash and Acquire Corporation stock would recognize realized gain to the extent of the cash received. The 70 percent shareholder's realized gain was $\$300,000 + \$400,000 - \$200,000 \text{ basis} = \$500,000$. If the reorganization requirements are satisfied, the shareholders' recognized gains are limited to the cash received of \$350,000, and the former 70 percent shareholder's basis in the Acquire Corporation stock is the same as his or her basis in the target stock, \$200,000. Acquire Corporation's basis in the assets received from Target is the same as Target's basis, \$250,000.

In regard to the continuity of interest requirements, consideration used by Acquire Corporation to purchase Target Corporation must consist of at least 40 percent Acquire Corporation stock, with the remaining consideration consisting of cash or other property. If the two purchases are combined, 65 percent of Acquire Corporation's total consideration given was cash (\$300,000 + \$350,000), and therefore, both transactions are taxable. However, the continuity interest measurement rules do not apply to the first purchase if that were a separate transaction unrelated to the second purchase. When the transactions are not related, the 40–60 consideration test is based solely on the second transaction. In the latter purchase, consideration was 50–50, cash and stock, and on the basis of those transactions alone, the continuity of interest requirement for a reorganization was satisfied. Accordingly, while the first transaction was taxable to those shareholders who sold their stock, the second would generally be tax deferred with gain recognized only to the extent of the \$350,000 cash received. For shareholders wanting to defer tax on the sale, their status depends upon separating the two transactions. In this example, the six-year passage of time between the transactions suggests they were unrelated.

Assuming that, in the example, tax-deferred reorganization treatment was warranted, Acquire's basis in the target assets is \$250,000, even though Acquire paid \$650,000 in cash for the stock. The acquiring corporation in a tax-deferred exchange sacrifices basis when the corporation's assets are appreciated. However, when the effects on both the corporation and the target shareholders are taken into account, the parties generally should structure the transaction as a reorganization. This is true because if one corporation acquires the assets of the target corporation in a taxable transaction, the target corporation will have taxable gain

and the target shareholders who receive consideration from the acquiring corporation will have taxable gain.

In the example shown in the following table, a stock for assets exchange that does not qualify as a reorganization will result in \$1,020,000 taxable gain for the target and shareholders. A corporate and shareholder tax will be due upon the exchange. Assuming the shareholder's basis in the stock is \$400,000, the corporate tax rate is 21 percent, and the shareholder capital gain rate is 15 percent, the combined corporate and shareholder tax would be as follows:

	Appraisal value of assets	Corporation's basis
Accounts receivable	\$70,000	\$80,000
Equipment	\$450,000	\$300,000
Building	\$600,000	\$300,000
Land	\$250,000	\$100,000
Secret formulas	\$130,000	\$0
Goodwill and going concern value	\$300,000	\$0
Total	\$1,800,000	\$780,000

Corporate tax = 0.21(\$1,020,000) =

Shareholder tax = 0.20(\$1,800,000 – \$214,200 –

\$400,000) =

Total tax

\$214,200

\$237,160

\$451,360

Without the benefit of tax-deferred reorganization treatment, Acquire would likely want to purchase the stock, rather than the assets of Target Corporation, and thus, avoid the corporate level tax of \$214,200. This is true because the future tax benefit to Acquire Corporation is \$87,110 (assuming a 10 percent rate of return and a 21 percent tax rate). It makes no sense for the corporation to incur \$214,200 tax for Acquire to get \$87,110 in future benefits (see Chapter 2). In addition, the target shareholders will be required to recognize gain. As a tax-deferred

reorganization, the basis of the target assets will remain the same (no step-up to market value) as in a taxable purchase of the stock, but the target shareholder will not recognize gain at the time of the sale. Therefore, if the shareholders wish to continue involvement in the modified, expanded business, a tax-deferred reorganization is a tax efficient means to accomplish those goals.

The B Reorganization

In a B reorganization, as depicted in Figure 5.2, one corporation exchanges solely its voting stock for stock of the target corporation, and immediately after the exchange, the acquiring corporation owns at least 80 percent of the stock of the target corporation.⁶ When the consideration is solely voting stock and the acquiring corporation has 80 percent control immediately after the exchange, the continuity of interest requirement is also satisfied. However, it should be noted that if the acquiring corporation gives any boot, the transaction becomes taxable to the shareholders. B reorganizations require total cooperation of the target shareholders. If some shareholders demand cash, the other shareholders who receive voting stock must recognize gain because the use of cash violates the solely voting stock requirement of B reorganization. Therefore, the transactions are best suited for target corporations with just a few shareholders.

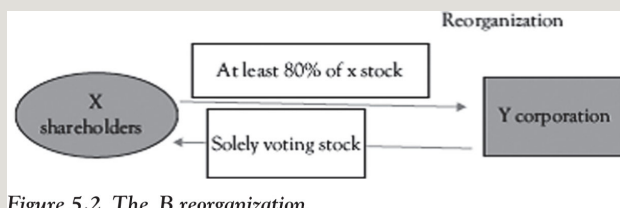


Figure 5.2 The B reorganization

The solely voting stock requirement is strictly construed.

However, the strict requirement of no boot in a B reorganization is not violated if the shareholder in the target continues as an employee and receives a salary, provided the salary is commensurate with the services the shareholder provides. Nor is a solely voting stock violated if the target corporation redeems some of the stock of its shareholders, provided the acquiring corporation does not provide the funds for the stock buy-back. Likewise, the solely voting stock requirement is not violated if the acquiring corporation has purchased the target stock in a separate, unrelated transaction such as the creeping acquisition consisting of two separate purchases as discussed in regard to the A reorganization.

As discussed earlier, when an attempted A reorganization fails, the target corporation must recognize gain, but the acquiring corporation gets a stepped-up basis in the target assets. However, a failed B reorganization does not trigger corporate level taxable income—the failed B reorganization merely causes the target shareholders to recognize gain. In one famous transaction, the parties deliberately structured the transaction so as to avoid B reorganization treatment. The acquiring corporation gave its stock with a value of \$2,000,000,000 and \$20,000 cash in exchange for all of the stock of the target, which continued to operate as a subsidiary of the acquiring corporation. The transaction did not qualify as an A reorganization since the target's assets were not transferred, and the transaction did not qualify as a B reorganization because of the \$20,000 cash. Therefore, the transaction was taxable. However, the target shareholder was not subject to tax in the United States, and thus, the realized gain was not taxable, while the acquiring corporation attained a stepped-up basis to fair market value in the target stock.⁷

The C Reorganization

The form of a C reorganization is much like an A reorganization. Assets are purchased from the target corporation, and the target shareholders receive voting stock in the acquiring corporation. The target corporation is liquidated. Unlike an A reorganization, the C reorganization does not need to meet state law requirements for a merger. However, the acquiring corporation must receive substantially all of the target corporation's property in exchange for voting stock in the acquiring corporation. Generally, the assumption of the target's liabilities are not treated as boot; however, if the acquiring corporation gives cash or other boot, the assumption of the liabilities are aggregated with the boot to determine if *substantially all* of the target assets were acquired for voting stock. If the sum of the liabilities assumed and the boot given exceed 20 percent of the value of the assets, the transactions are taxed as a sale. No such limitation applies to an A reorganization; rather all that is required in terms of consideration is that at least 40 percent of the value that the acquiring corporation pays consists of acquiring corporation stock.

B or Failed B Followed by Liquidation

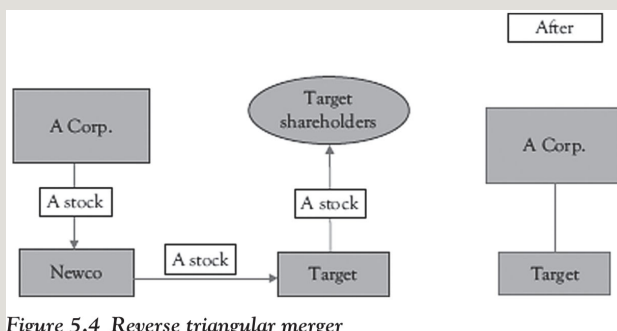
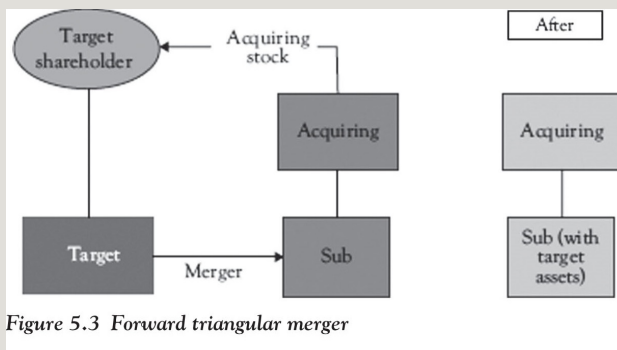
In a B reorganization, the acquiring corporation is left with a subsidiary, while in an A or C reorganization, the acquiring corporation generally absorbs the target's assets and liabilities. If the acquiring corporation acquires the target corporation in a stock for stock exchange and immediately liquidates the target, the transactions will be evaluated in terms of the requirements of a C reorganization. Thus, under circumstances where the B requirements were violated because boot was given, the target could be liquidated and provided that the 80 percent of assets for stock requirements for a C reorganization are satisfied, the transactions could still qualify as a C reorganization.

Triangular Reorganizations

When the target assets are acquired in an A or C reorganization, usually the target corporation's liabilities follow the assets. As a result, the acquiring corporation may find itself burdened with the target liabilities that were unknown at the time of the acquisition. One way of acquiring a corporation as a nontaxable reorganization while avoiding a surprise is to merge the target corporation into a newly formed subsidiary of the acquiring corporation. This technique is referred to as a *forward triangular reorganization*. Generally, to be nontaxable, it must meet the requirements of an A reorganization, except the target is merged into the acquiring corporation's subsidiary, rather than merging into the parent.

In the forward merger depicted in Figure 5.3, the target corporation is dissolved. Often it will be necessary to keep the target *alive*. For example, the target's survival may be necessary to keep contracts in place. This can be accomplished as a reverse triangular merger. The pattern is as follows: The parent will create a new corporation (Newco) whose only asset is stock of the parent. The newly formed corporation will be merged into the target, which simply means the target will receive the parent stock, which the target will distribute to its shareholders in exchange for the target stock. The target assets will, therefore, remain beneath the target corporate shell.

The requirements for a nontaxable reverse triangular reorganization are the same as for an A reorganization, except for the continuity of interest depicted in Figure 5.4. Under the reverse triangular reorganization, the acquiring corporation's consideration paid must be at least 80 percent voting stock.



Unwanted Assets

The target corporation may own assets that the acquiring corporation does not need or want. The acquiring corporation may simply take the bad with the good and deal with the unwanted assets after the reorganization. However, a postacquisition disposition of the target assets raises issues for the *continuity of business enterprise* requirement of a reorganization. This should not be a problem for an A (statutory merger) or B reorganization provided that a significant portion of the target's assets continues to be used in the business; that is, the retained asset used in the business must be a significant portion of the target's assets. According to Treasury regulations, a retention of one-third of the assets is sufficient.⁸

When the target disposes of the unwanted assets prior to the completion of the reorganization, the consequences of shedding the unwanted assets can depend upon the type of reorganization employed. If the target is acquired in an A or B reorganization, the only issue is with the continuity of business enterprise requirement, which is the same as when the unwanted assets are sold immediately after the reorganization. However, dispositions preceding an attempted C reorganization can cause problems. A requirement of the C reorganization is that the target corporation must transfer *substantially all* of its assets. A disposition of significant assets immediately preceding and as part of the plan for the attempted C reorganization could mean that less than substantially all the assets were transferred.

For many years, a commonly used technique for disposing of an unwanted business was through a spin-off. In a landmark case, *Morris Trust*, a state bank owned an insurance business.⁹ The state bank wanted to merge with a national bank that at the time was prohibited from owning an insurance business. To facilitate the merger, the state bank distributed its stock (100 percent of outstanding stock) to its shareholders in a transaction that qualified as a nontaxable spin-off (no gain or loss to the state bank or its shareholders). Then the statutory merger was completed. Over 20 years later, Congress decided that allowing both the spin-off and the merger to be accomplished in a tax-deferred manner was bad policy. Therefore, IRC was amended to generally require the parent corporation to recognize gain (the difference between fair market value of the subsidiary stock and the parent's basis) from distributing the stock, when the spin-off is in conjunction with another reorganization in which the distributing corporation's shareholders own less than 50 percent of the stock of the merged corporations after the merger.¹⁰

Summary

The tax-deferred reorganization can be beneficial to the parties disposing of their interests in a corporation in that the realized gain can be deferred until the stock received in the acquiring corporation is sold. The investment in one corporation can be *rolled over* into another corporation without the sting of a tax on the exchange. But the conditions must be right for the reorganization to occur.

The acquiring corporation does not directly benefit from structuring the purchase as nontaxable. This is true, because in a taxable acquisition, the acquiring corporation gets the benefits of stepping up assets bases. However, as was discussed in connection with taxable acquisitions, the present value of the tax benefits from stepping up bases—benefits that will be spread over future years—is generally not as great as the additional tax burden on the seller.

¹ The reorganizations are tax deferred in that tax is typically due upon the sale of the new acquiring corporation stock.

² Section 368(a)(1).

³ Reg. §1.368-1(a)-(d).

⁴ Reg. §1.368-1(d)

⁵ Reg. §1.368-1(e).

⁶ The control requirement is set forth in Section 368(c): “Control defined . . . the term *control* means the ownership of stock possessing

at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.”

⁷ Ameritrade-TD Waterhouse, discussed in R. S. Bernstein. Nov/Dec, 2005. “Intentionally Taxable Stock Acquisitions.” *Corporate Taxation* 32, no. 6, p. 36.

⁸ Reg. §1.368-1(d)(5)(Example 1)

⁹ *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966)

¹⁰ Section 355(e).

CHAPTER 6

Business Investigation Costs

In this chapter, the tax treatment of the costs associated with - deciding which business to acquire will be discussed. Depending on the circumstances, these business investigation expenditures may be currently deductible or be capitalized and amortized over a period of time or be deemed insufficiently connected to a trade or business to justify a tax deduction at all.

Business Investigation Expense

Often, substantial time, effort, and out-of-pocket expenditures are required to determine whether to acquire a business, and if so, which business to acquire. Business investigation costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, and so on, and are costs in addition to the acquisition costs of the business. These investigatory costs are incurred to review a prospective business prior to reaching a final decision to acquire or enter that business. Unless the taxpayer is already engaged in the line of business being investigated, the expenses are not trade or business expenses.¹ When the expenditures relate to a new line of business, the investigatory costs are capitalized and amortized over 180 months.² In case the project is abandoned, the investigatory costs are deducted as a loss.³

A Business That Is New to the Taxpayer

Business investigation costs are deductible only if they are in connection with an existing trade or business. The tax rules for the treatment of business investigation costs were created by amending an already existing code section that dealt with *start-up costs*.⁴ The major problem for both types of costs is that under court decisions, costs cannot be *trade or business expenses* if the business had not begun when the costs were incurred.⁵ Searching for a business is not conducting a business. The fact that the business was eventually begun did not alter the character of the prior costs. That is, the inability to deduct the costs was not due to the nature of the expenditure, rather the timing of the expenditures was the issue. For example, employee training costs incurred before the business was open to customers were not incurred in the operation of the business, and therefore, could not be trade or business expenses. While the costs would have been deductible had the business been open to serving customers, these preopening expenditures became capital expenditures, an intangible asset. Without a definite useful life, they could not be amortized, and therefore, did not result in any tax benefits until the business was sold.⁶ The statute first addressed only start-up costs, costs incurred after the decision to enter the business but prior to business operations, and permitted amortization of the costs over 180 months. Later, IRC was amended to afford the same treatment to costs of investigating whether to enter or acquire a business.⁷

Investigatory costs precede start-up costs and are “costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter the business.”⁸ These costs are never currently deductible for lack of an affinity to an existing business. The expenditures are not personal provided that the costs are

actually incurred with the objective of acquiring or entering the business. If the costs are taken into account for tax purposes but are not currently deductible, by default the expenditures are capitalized. Fortunately, section 195 allows the capitalized amount to be amortized (and deducted) over 180 months. Thus, the special business investigation rules apply to costs incurred in “creating, or investigating the creation or acquisition of, a trade or business entered by the taxpayer.”⁹ But the expenditure “must be one which would be allowable as a deduction . . . if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.”¹⁰ If these conditions are satisfied, the costs must be capitalized but can be amortized as a deduction over 180 months, once the business is begun or acquired. If the business investigated is not acquired, the capitalized costs can be deducted as an ordinary trade or business loss.

As mentioned earlier, the capitalization of investigatory costs is not an issue for the taxpayer who is already in a particular trade or business and is incurring costs to expand by acquiring other entities in the same type of business. These costs are generally currently deductible.

Revenue Ruling 99-23 provides the following example¹¹:

Situation 1

In April 1998, corporation *U* hired an investment banker to evaluate the possibility of acquiring a trade or business unrelated to *U*’s existing business. The investment banker conducted research on several industries and evaluated publicly available financial information related to several businesses. Eventually, *U* narrowed its focus to one industry. The investment banker

evaluated several businesses within the industry, including corporation *V* and several of *V* 's competitors. The investment banker then commissioned appraisals of *V* 's assets and an in-depth review of *V* 's books and records in order to determine a fair acquisition price. On November 1, 1998, *U* entered into an acquisition agreement with *V* to purchase all the assets of *V*. *U* did not prepare and submit a letter of intent, or any other preliminary agreement or written document evidencing an intent, to acquire *V* prior to executing the acquisition agreement . . .

In *Situation 1*, an examination of the nature of the costs incurred indicates that *U* made its decision to acquire *V* after the investment banker conducted research on several industries and evaluated publicly available financial information. The costs incurred to conduct industry research and review public financial information are typical of the costs related to a general investigation. Accordingly, these costs are investigatory costs eligible for amortization as start-up expenditures under §195. However, the costs related to the appraisals of *V* 's assets and an in-depth review of *V* 's books and records to establish the purchase price facilitate consummation of the acquisition, and thus, are capital acquisition costs. The costs incurred to evaluate *V* and *V* 's competitors also may be investigatory costs, but only to the extent they were incurred to assist *U* in determining whether to acquire a business and which business to acquire. If the evaluation of *V* and *V* 's competitors had occurred after *U* had made its decision to acquire *V* (e.g., in an effort to establish the purchase price for *V*), such evaluation costs would be capital acquisition costs.

Once the decision has been made to acquire a particular business, the additional costs (e.g., appraisal fees, legal fees) become a cost

of and are allocated among the assets acquired.

The Expansion of an Existing Business

The planned acquisition to expand an existing business does not raise business investigation issues. However, the cost incurred may facilitate the acquisition of particular assets. For example, a retailer considers purchasing another retail operation, and professional fees are incurred to study two different businesses, one of which is finally acquired. The fees associated with the failed acquisition are deductible, but the fees associated with the business that is acquired must be capitalized as a part of the cost of the assets acquired. The costs of the assets are deductible as depreciation and amortization, over their tax lives.

¹ *Richmond Television Corp. v. U.S.*, 354 F.2d. 410 (4th Cir. 1965).

See, generally, J.W. Lee. 1986. Start-up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-on Tax Reform, and A Touch of Basics.” *Virginia Tax Review* 6, no. 1, pp. 46-51.

² See, e.g., *Haskins v. Comm’r*, 45 T.C.M. (CCH) 359; *York v. Comm’r*, 261 F.2d 421, 422 (4th Cir. 1958).

³ Section 165.

⁴ Section 195(c).

⁵ *Richmond Television Corp. v. U.S.* 354 F.2d. 410 (4th Cir. 1965), see note 1.

⁶ See H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980).

⁷ Section 195(c)(1)(A)(i). See, generally, G. Walberg. 2010.

“Reconsidering the Treatment of Investigatory Costs for Taxpayers with Existing Businesses.” *Houston Business and Tax Journal*, 10, p. 47.

⁸ Rev. Rul. 99-23, 1999-1 C.B. 998.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

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